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91-01 The Department of Finance June 1991

The Deficit and the Public Debt

A key goal of the 1991 budget and the Plan for Economic Recovery is to reduce the burden of the public debt and eliminate the need for new government borrowing on financial markets. To meet this goal, the government is taking firm action to control spending. The result will be a dramatic drop in the deficit and government financial requirements by 1992-93.

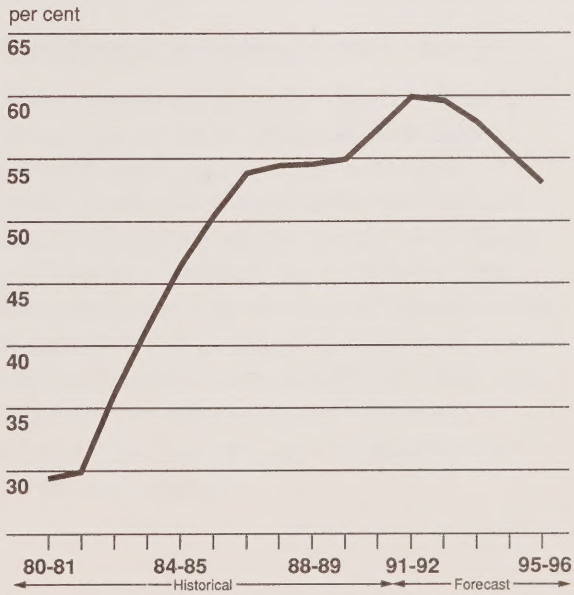
The Growth of the Problem

- The federal government has incurred a deficit each year since 1970 – spending more than its revenues. This deficit, which must be borrowed, grew from less than $1 billion in 1970-71 to a record $38.5 billion in 1984-85.
- Deficit spending has caused our public debt to soar from $20 billion to almost $400 billion in two decades. Interest charges on the debt were $43 billion in the 1990-91 fiscal year.
- All of the increase in the amount of debt since 1984-85 consists of compound interest on the debt that was already in place at that time.
- For every dollar of federal tax revenue today, 36 cents goes to pay debt interest. If there were no debt, the government would have a $12.5 billion surplus – money that could be used to reduce taxes or pay for desired programs and services.

Making Progress to Fiscal Balance

- Since 1984-85, the deficit has been cut from $38.5 billion to $30.5 billion last year. As a percentage of gross domestic product – Canada's national income – the deficit was reduced from 8.7 per cent to 4.5 per cent.
- The deficit will be held at $30.5 billion in 1991-92 and will fall below $25 billion in 1992-93 for the first time in a decade. It is projected to decline to $6.5 billion by 1995-96.
- The growth of the debt will continue to slow and its burden will begin to decline in 1992-93 as the public debt begins to shrink as a percentage of gross domestic product (GDP).
- The need for new government borrowing on financial markets will be eliminated by 1994-95. This will represent the first time in 25 years that no such borrowing is needed.

The Debt-to-GDP Ratio: 1980-81 to 1995-96



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Restraint of Government Wages

The 1991 budget proposed a number of important measures to ensure that the deficit and the burden of the public debt will be reduced in the years ahead as part of the Plan for Economic Recovery. The proposed Spending Control Act will reinforce a continuing program of spending restraint including new measures to further restrain the federal government's wage costs.

Tough Wage Restraint Measures

As a leading employer, the federal government has a responsibility to ensure that public sector wage settlements do not add to inflation pressures in the economy. The 1991 budget contained measures, subsequently reinforced by the President of the Treasury Board, to limit wage settlements with federal employees. The measures include:

- There will be no increase in wage levels for fiscal year 1991-92;
- For the following two fiscal years, wage settlements will not exceed three per cent;
- Ministerial pay for the Prime Minister and Cabinet members will be frozen for one year; and,
- Salary increases for the executive category, deputy ministers and heads of Crown corporations will be limited to the average of negotiated settlements in the federal public service. Salaries of Members of Parliament and the Senate will be similarly restrained.

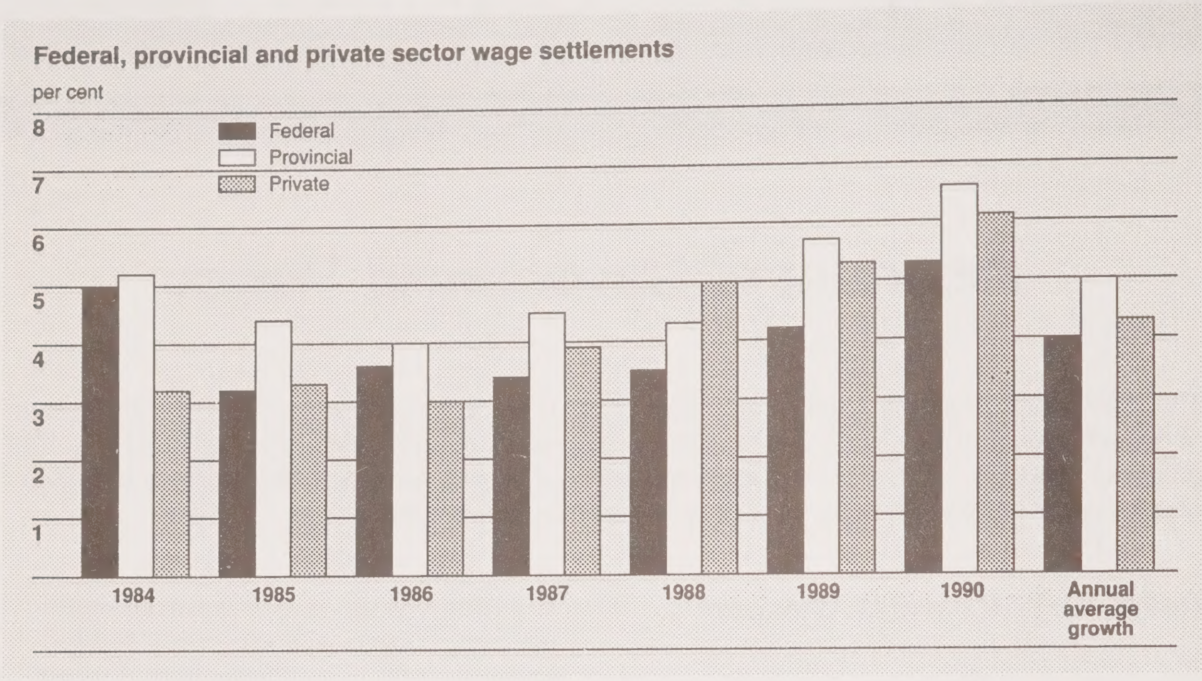
In addition, capital spending and non-wage operating budgets will be frozen at 1990-91 levels for 1991-92 and the number of senior managers in the public service will be reduced by 10 per cent.

Significant Savings

These measures will generate savings of $685 million in 1991-92. Ongoing savings will be realized in the medium term.

Keeping Operating Costs Down

The measures are part of a broader effort to restrain government operating costs and program spending. As a result of tight restraint, operating costs have been reduced almost 20 per cent in real terms (after taking inflation into account) since 1984-85. Over the same period, the number of federal Crown corporation and government employees has been reduced by more than 90,000. This was achieved through improving efficiency, eliminating programs, and the government's privatization program.



Continuing restraint has led to a reduction in government spending on operations from 19.3 per cent of total program spending in 1984-85 to 16.6 per cent in 1990-91.

Federal Government Leadership in Public Sector Wage Restraint

To reduce inflationary pressures, wage restraint by all levels of government, as well as the private sector, is particularly important. Since 1986, federal wage settlements have consistently been lower than those concluded in the private sector, and lower than those agreed to by provincial and municipal governments.

Since the federal budget was presented in February, seven provinces have introduced similar public sector wage restraint measures.

An easing of wage pressures in the private sector will also have beneficial effects. Reducing cost pressures throughout the economy will permit interest rates to fall further. Lower interest rates will help generate productive economic activity and encourage job creation.

Further information on the proposed Spending Control Act is available in the form of a booklet and a more detailed background paper. To request copies, write or telephone: Distribution Centre, Department of Finance, Ottawa, K1A 0G5 (613) 995-2855.

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Canada’s Inflation Targets

Reducing inflation and inflationary expectations are critical steps to keep interest rates down. Achieving price stability will enhance Canada’s international competitiveness and sustain economic recovery. To help achieve these goals, the government’s 1991 budget – as part of the Plan for Economic Recovery – set out inflation targets for the next five years.

The government and the Bank of Canada are seeking to reduce the year-over-year increase in the consumer price index (CPI) to 3 per cent by the end of 1992; to 2½ per cent by the middle of 1994; and to 2 per cent by the end of 1995.

Inflation and Interest Rates

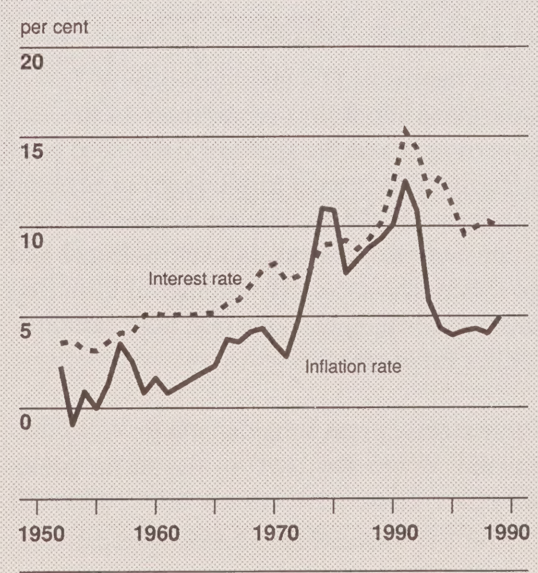
Inflationary pressure is a primary cause of higher interest rates, as lenders demand a “risk premium” from borrowers to compensate for the decline in the value of money during the period of the loan. That is why countries such as Japan and Germany, which have had low rates of inflation, typically enjoy the lowest interest rates.

The relationship between interest rates and inflation is illustrated in the chart comparing the annual increase in the consumer price index with the average yearly interest rate on long-term government bonds, an important measure of overall interest rates. It shows how rising inflation is followed by increases in interest rates.

Moving to Recovery

A number of the pressures that lead to higher inflation – such as excessive credit growth and wage settlements – have eased over the past year. This has made possible a significant decline in short-term interest rates, which have fallen more than 5 percentage points from their 1990 peak. In turn, this has

Inflation and interest rates



helped produce the recent gains in home construction and sales and other economic activity that indicate Canada is on the path to economic recovery and growth.

However, getting interest rates down further and keeping them down will depend on our national ability to reduce inflation and inflationary behavior and expectations. The Plan for Economic Recovery aims at achieving this in three ways:

- by getting the government's finances under better control so it can stop borrowing and adding to the national debt;
- by adopting a responsible anti-inflation wage policy for Parliament and the federal public service, and encouraging other levels of government to do the same;
- by setting out clearly the inflation targets of the government and the Bank of Canada.

The Importance of Inflation Targets

These targets send a clear message to Canadians about the commitment of the government and the Bank of Canada to price stability. This lowers inflationary expectations and provides the confidence needed for us all – consumers, business, labour, investors and governments – to work together to limit the price and wage pressures that push inflation higher for everyone.

Price stability can help Canada to avoid the painful "boom and bust" cycles of the past 20 years. These have largely been caused by letting inflation get out of control.

With Canadians committed to clear, public inflation targets, we can plan and act with confidence that our incomes and savings will maintain their value. Even if a specific "price shock" – for example, a jump in world oil prices – does push up inflation for a time, firm public expectations that inflation will be kept low should keep the impact from spreading. That has been the experience of Germany and Japan, where pressures such as energy costs have not resulted in long-lasting high inflation.

A Realistic Approach

The inflation targets in the Plan for Economic Recovery are realistic. Canada has achieved a low rate of inflation in the past and can do so again. Only since the 1970s has our inflation performance fallen behind countries like Germany and Japan.

The rewards of lower inflation are clear and concrete. Interest rates will come down. Business costs will grow more slowly, and economic productivity and competitiveness will increase. And this will lay the foundation for an improved standard of living for all Canadians.

International comparison, 1984-90

	Canada	U.S.	Germany	Japan
Inflation rate (CPI)[1]	4.4	3.9	1.5	1.4
Interest rates[2]	10.3	9.7	7.0	5.7
Unit labour cost[1]	4.7	3.6	1.8	0.9

[1] Average annual percentage increase
[2] Average annual rate

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Debt Servicing and Reduction Account

The 1991 budget proposed a number of important measures to ensure that the deficit and the burden of the public debt will be reduced in the years ahead as a key part of the Plan for Economic Recovery. One of these measures is the proposed Debt Servicing and Reduction Account.

A Special-Purpose Fund to Tackle the Debt

The government has introduced legislation to establish the Debt Servicing and Reduction Account.

Revenues in the proposed Account will be used to pay the interest on the public debt and, over time, to pay down the net debt.

Into this Fund will flow:

- net revenues from the Goods and Services Tax;
- net proceeds from the sale of Crown corporations; and
- gifts to the Crown.

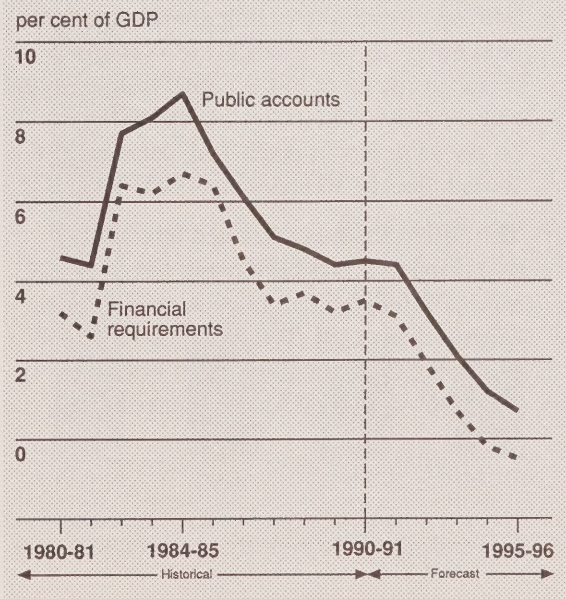
The Account will be audited annually by the Auditor General.

Greater Assurance for Deficit Reduction

The establishment of the Account backs up the government's commitment to ensure that GST revenues will make a sustained contribution to deficit reduction.

The Account provides assurance that GST revenues will not be used to fund new spending – and will be used to reduce the deficit and, over time, the debt.

The deficit and financial requirements[1]
1980-81 to 1995-96



[1] Excluding foreign exchange transactions.

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Reinforcing the Initiative

To reinforce this initiative, the government also proposed in the budget to legislate limits on total program spending.

If spending were to exceed allowable limits for economic or policy reasons, reductions would have to be found. And borrowing or increases in taxes – including the GST – would not be allowed to fund excess spending.

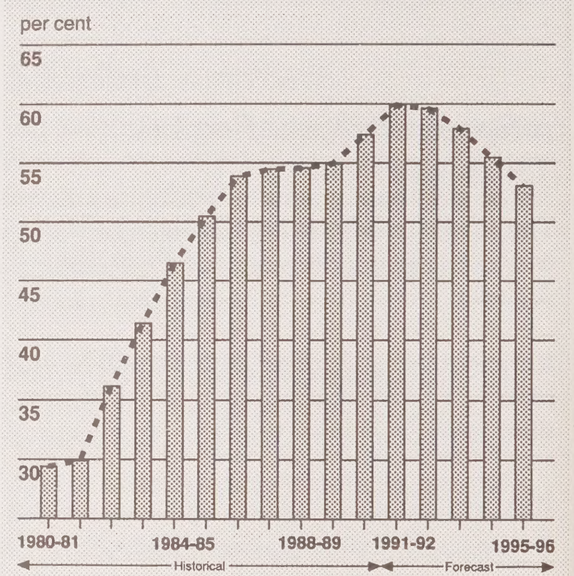
Once approved by Parliament, the proposed Debt Servicing and Reduction Account and the proposed *Spending Control Act* will be effective for the 1991-92 fiscal year which began April 1, 1991.

Sustaining Fiscal Progress

These measures will play vital roles in sustaining progress in restraining program spending, reducing the deficit and controlling the debt.

- Federal program spending growth has been held below inflation since 1984. Total program spending has dropped from 19.6 per cent of gross domestic product (GDP) to 16 per cent. It will reach 14.5 per cent, the lowest level in 30 years, by 1995-96.
- The deficit has been reduced by about $8 billion to $30.5 billion and has been cut almost in half as a proportion of GDP from 8.7 to 4.5 per cent. The deficit is projected to decline dramatically to $6.5 billion by 1995-96 – less than one per cent of GDP.
- Financial requirements – the additional funds that must be borrowed on financial markets to help cover the deficit each year – will be eliminated by 1994-95. The government will then begin reducing its publicly held debt.
- The growth of the debt has been slowed significantly. The debt will begin to decline as a share of GDP in 1992-93.

The debt-to-GDP ratio: 1980-81 to 1995-96



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The Proposed Spending Control Act

As a vital part of the Plan for Economic Recovery, the 1991 budget provides for continued firm control of government program spending to reduce the deficit and the burden of the debt.

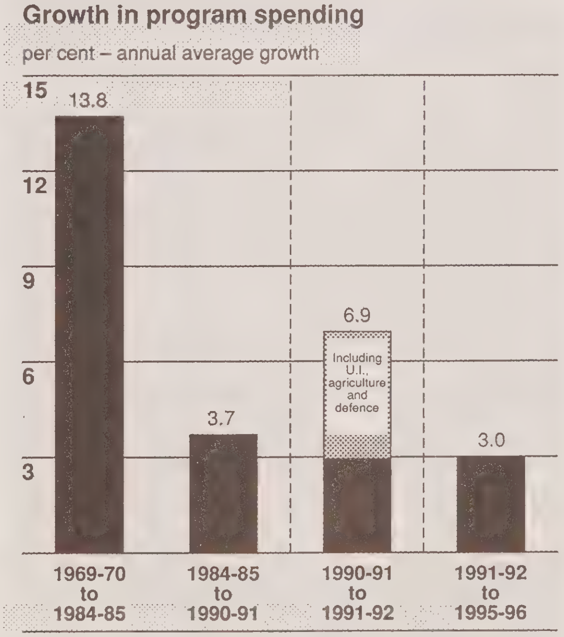
To provide maximum assurance of spending restraint, the budget also announced the government's intention to impose mandatory limits on annual program spending.

The draft Spending Control Act has been released for public discussion and study by the House of Commons Standing Committee on Finance prior to final legislation in the fall.

Spending Restraint Will Be Legislated

The proposed Spending Control Act puts a ceiling on government program spending – all spending except interest on the public debt – for each of the next five years.

- The allowable limits are the program spending projections contained in the fiscal plan presented in the February 1991 budget.
- Under these projections, program spending would be held to an average annual increase of 3 per cent between 1991-92 and 1995-96.
- With limited exceptions, overspending would have to be offset by program spending reductions.
- The Act would not allow either increased borrowing or tax increases to make up for any excess spending that might occur.



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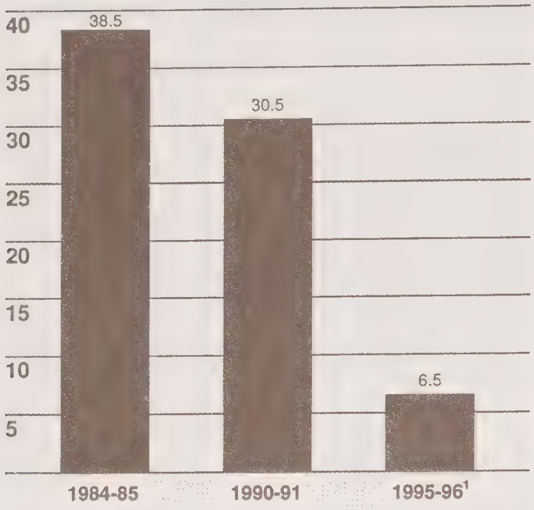
Budgetary deficit

billions of dollars



¹ Forecast.

Source: Department of Finance.

Ensuring Accountability

Program spending above the legislated limit in a particular year will have to be made up in the subsequent years of the legislation or, at the discretion of the Minister of Finance, from cumulative under-spending in previous years, to ensure that the total spending limit from 1991-92 to 1995-96 is not exceeded.

If the limit is exceeded, the Minister of Finance must announce before or in the next budget how this excess would be recovered over the remaining years of the legislation.

A budget that is not consistent with the Spending Control Act could not be presented without, at the same time, presenting legislation to amend the Act.

Dealing With Contingencies

It is important to ensure that the controls are consistent with the efficiency or effectiveness of government operations and the ability to respond to contingencies. As a result, a limited number of exceptions are permitted under which the limits could be exceeded. They are: spending related to emergencies, disasters and external shocks; losses from the sale of assets; higher spending on self-financing programs; incremental funding for good management initiatives such as enhanced service and related cost-recovery to improve efficiency and reduce the deficit; and adjustments resulting from events occurring prior to 1991-92, such as revisions in data affecting past payments under a formula-funded program, or court decisions relating to programs in effect prior to 1991-92.

Comparison with U.S. Limits

Canada's proposed Spending Control Act provides for tighter control of spending than the United States' Budget Enforcement Act of 1990 – the successor to the "Gramm-Rudman-Hollings" Act. For instance:

- While the exemptions from spending limits are minimal in Canada, in the U.S. all entitlement or statutory programs are exempted from changes due to economic reasons.
- For all other programs, the U.S. spending limits are adjusted on an ongoing basis for changes in inflation. No adjustment would be allowed under Canada's Spending Control Act.
- The Canadian law would prohibit increasing taxes to expand the spending limits, while the Budget Enforcement Act in the U.S. permits new spending initiatives to be financed through higher taxes as long as the deficit is not adversely affected.

Meeting the Challenge of Spending Restraint

Living within the program spending limits of the proposed Spending Control Act will require difficult choices among competing spending pressures – spending more on some things will mean spending less on others. The

government has demonstrated its continuing commitment to expenditure restraint and the difficult choices it requires.

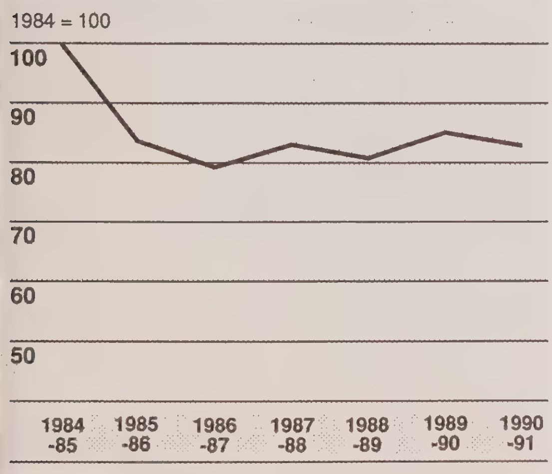
A Real Reduction in Program Spending

In the 15 years before 1984-85, program spending had been increasing at an average annual rate of 13.8 per cent. Since then, the growth in program spending has been reduced to 3.7 per cent – less than the rate of inflation and therefore a reduction in real terms. Program spending as a share of annual economic output has been reduced from 19.6 to 16 per cent. It is projected to fall further to 14.5 per cent by 1995-96 – the lowest level in almost 30 years.

Major Turnaround in the Operating Balance

Since 1984-85 the operating balance – program spending compared with revenues – has been turned around from a $16.1 billion deficit to a $12.7 billion surplus. The large majority of this progress results from expenditure restraint.

Index of real operating costs
Federal government, 1984-85 to 1990-91



Cost of Government Operations Tightly Restrained

Government operating costs – salaries, travel, accommodation and other overhead costs – have been tightly restrained, growing by an annual average of only 1.2 per cent since 1984-85. In real terms (after accounting for inflation) this means the cost of government operations declined by almost 20 per cent since 1984-85, as shown in the preceding chart.

As a proportion of total program expenditures, operating costs have declined from 19.3 per cent in 1984-85 to 16.6 per cent in 1990-91.

Reducing the Deficit and the Burden of the Debt

The deficit has declined from its peak of 8.7 per cent of annual economic output in 1984-85 to 4.5 per cent in 1990-91. It is projected to decline to less than one per cent by 1995-96.

The burden of the debt on the economy will begin to decline next year and the government will begin to buy back its publicly held debt in 1994-95.

The Expenditure Control Plan

In the 1990 budget, the government introduced the Expenditure Control Plan, a comprehensive two-year approach to expenditure control and reduction.

This Plan was extended into the medium term in the 1991 budget. In addition, tough new restraints on government salaries and all other operating costs were put into place.

No funds have been provided for negotiated wage increases in the current year; the number of senior managers will be reduced by 10 per cent; and there will be no growth in capital and non-wage operating budgets.

To further reinforce the Expenditure Control Plan and the legislated spending limits, the budget introduced two other key pillars of the Plan for Economic Recovery: a set of inflation targets to systematically reduce both inflation and inflationary expectations, and the Debt Servicing and Reduction Account (all net GST revenues will go into this fund to pay the interest on the public debt and, over time, to pay down the debt itself).

To Recovery and Prosperity

Sustained spending restraint will pay large dividends. A lower deficit will ease pressure on inflation, interest rates and taxes. Canada's ability to compete in a tough economic world will be strengthened. This will help ensure strong economic recovery and the sustained future growth and prosperity that brings new jobs and higher incomes.

Further information on the proposed Spending Control Act is available in the form of a booklet and a more detailed background paper. To request copies, write or telephone: Distribution Centre, Department of Finance, Ottawa, K1A 0G5 (613) 995-2855.

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91-06 The Department of Finance July 1991

Breaking the Vicious Circle of the Debt and Deficit

Since 1984, direct action has been taken against the federal deficit. Expenditures on a wide range of government programs have been eliminated, reduced, frozen or restrained. In addition, given the seriousness of the fiscal situation, some tax increases have been necessary.

Real fiscal progress has been made and many Canadians are asking that further progress be made. The effort continues and we are very close to turning the corner in the battle to strengthen Canada's economy by reducing the deficit and the burden of the debt. Yet, in spite of the progress, the debt has almost doubled to about $400 billion in the past seven years.

The Self-Propelling (Inherited) Debt

The problem we are facing is the compounding interest on the debt that was already in place when the government launched this fiscal battle.

In 1984-85, the annual deficit was about $38.5 billion. This consisted of $22.4 billion in interest charges and a $16.1 billion operating deficit – the amount by which spending on programs exceeded revenues. The following table shows how the make-up of the deficit has changed since that time:

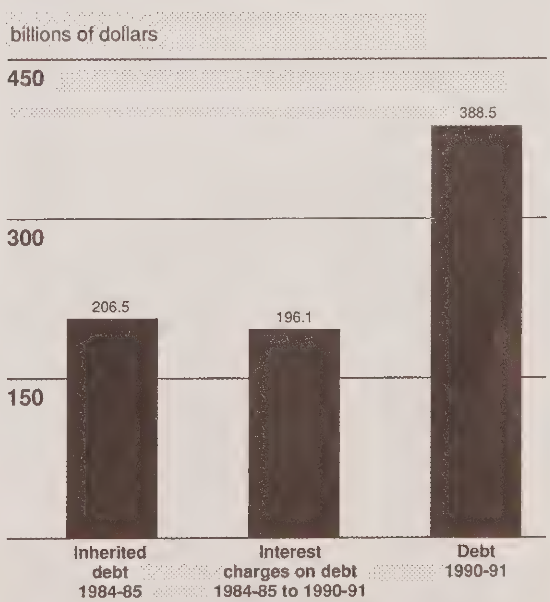
Composition of Annual Deficits (billions of dollars)

	Debt interest	+	Operating balance	=	Deficit
1985-86	-25.4		-9.1		-34.4
1986-87	-26.7		-4.1		-30.7
1987-88	-29.0		+0.8		-28.2
1988-89	-33.2		+4.2		-28.9
1989-90	-38.8		+9.8		-28.9
1990-91	-43.0		+12.5		-30.5
Total	-196.1		+14.1		-182.0

Numbers may not add due to rounding.

The growth of the debt since 1984-85 is *entirely* the result of compounding interest on the original debt. The debt today would be $14.1 billion higher except for the fact that since 1987-88, we have been paying for all our spending on programs and using the operating surplus to pay for some of the debt interest.

Chart 1
Debt interest and the increase in debt[1]



[1] 1990-91 debt equals 1984-85 debt plus interest charges minus the operating surplus during that period.

The public debt is the sum of all annual deficits since Confederation. Each year's deficit gets added to the existing debt. Chart 1 shows the increase in the debt from the 1984-85 fiscal year to 1990-91. As the chart shows, the debt increased in total by $182 billion and this was more than accounted for by the increase of $196.1 billion in compound interest on the debt.

In 1984-85, the deficit was clearly the result of *two* sets of bad news: the interest on the debt and program spending sharply in excess of revenues. Today the deficit is a mixture of the bad and the good: much higher debt interest due to compounding interest charges, but an operating surplus and one that has been steadily increasing since 1987-88.

The Record of Expenditure Management

Further increases in the operating surplus will be the key to bringing the deficit down and the debt under control.

The turnaround in the operating balance – from a huge deficit to a large and growing surplus – has been achieved in large part through the program spending restraint that has been increasingly put into effect since late 1984.

Chart 2 shows the dramatic contrast between the average annual growth of program expenditures for two periods, 1979-80 to 1984-85 and 1984-85 to 1990-91 – a reduction from 13.8 per cent to 3.7 per cent. In the earlier period, program spending grew substantially faster than the economy – faster than the country's ability to afford it – and faster than inflation. Since 1984-85, program spending growth has been held to less than that of the economy – and also less than inflation.

This means that real spending on government programs – actual spending minus inflation – is significantly less today than it was in 1984.

Where did spending restraint bite the hardest? Chart 3 shows the growth of some of the components of program spending since 1984-85.

Chart 2
Total program spending

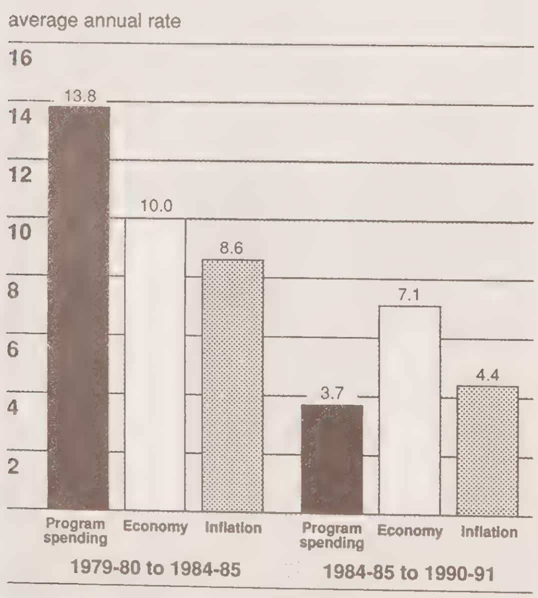


Chart 3
Program spending growth 1984–85 to 1990–91

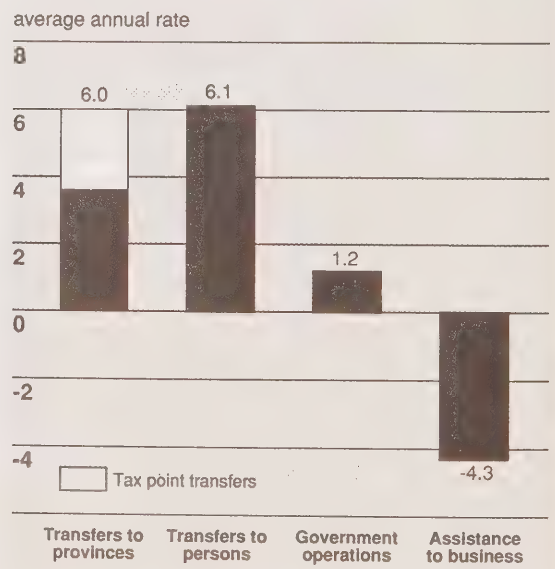
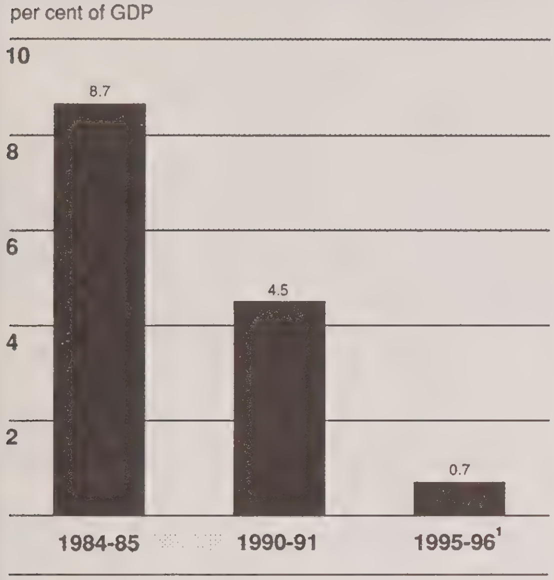


Chart 4
Budgetary deficit



[1] Forecast.
Source: Department of Finance.

Tranfers to persons

Transfers to persons – such as old age security, unemployment insurance, family allowances – grew well above the average at 6.1 per cent, clearly reflecting the priority placed on this area.

Transfers to provinces

At 3.6 per cent annual growth, cash payments to provinces – for education, health and other services – increased at about the same rate as all federal program spending. Including the transfer of tax points associated with these programs, these transfers grew by 5.6 per cent.

Government operations

By contrast, the operations of government – including salaries, equipment, and travel – grew by only 1.2 per cent. This represents a drop of almost 20 per cent in the real, after-inflation cost of operating the government.

These operating costs also dropped from 19.3 per cent of total program spending in 1984-85 to 16.6 per cent in 1990-91.

Assistance to business

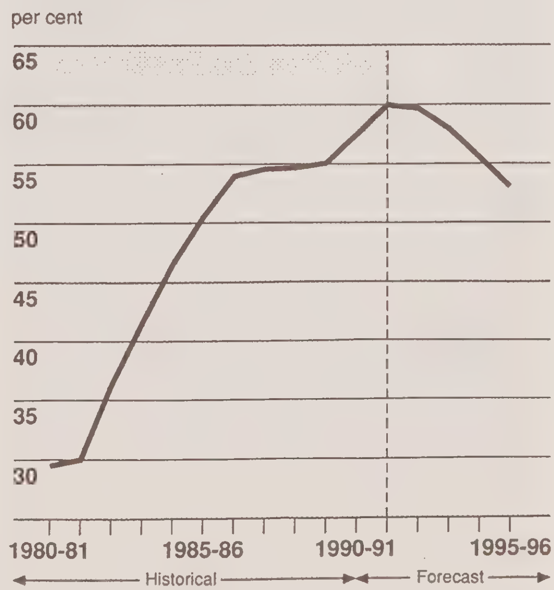
Finally, assistance to business was reduced over the period at an average annual rate of 4.3 per cent in nominal terms.

Making progress to fiscal balance

The actions in the February 1991 budget will hold the deficit to the same level this year as last year – about $30.5 billion. In 1992-93, the deficit will fall below $25 billion for the first time in a decade. As the recovery progresses, the deficit is forecast to decline rapidly, year by year, to reach $6.5 billion by 1995-96.
As a percentage of gross domestic product – Canada's national income – the deficit was reduced from 8.7 per cent to 4.5 per cent from 1984-85 to 1990-91. It is projected to fall to 0.7 per cent of GDP by 1995-96.

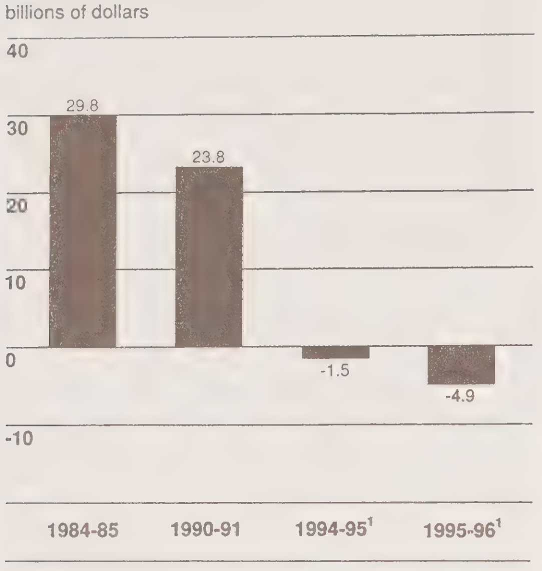
After almost two decades in which the debt has grown sharply as a proportion of Canada's economy, the tide will turn in 1992-93 as the economy begins to grow faster than the debt.

Chart 5
Federal debt-to-GDP ratio[1]
1980-81 to 1994-95



[1] Public accounts basis.
Source: Department of Finance.

Chart 6
Financial requirements



[1] Forecast.
Source: Department of Finance.

Strengthening this trend will be the key to reducing the burden of the debt in the years ahead.

In 1994-95, for the first time in 25 years, the government will no longer be borrowing additional net funds in the financial markets and will begin to buy back its bonds and Treasury bills.

The Plan is Working

The government has taken a firm, carefully selective and sustained approach to expenditure restraint and deficit reduction – an approach reinforced by further tough fiscal actions as part of the Plan for Economic Recovery brought forward in the 1991 budget.

In addition to sustained expenditure control, the plan is based firmly on three other pillars: inflation targets designed to reduce inflation and inflationary expectations, and create further scope for lower interest rates; legislated program spending limits; and the Debt Servicing and Reduction Account (all net GST revenues will go into this fund to pay the interest on the public debt, and, over time, to pay down the debt itself). Step by step, Canada's fiscal and economic challenges are being met. As an essential part of this plan, the vicious circle of the debt and the deficit must and will be broken.

For more information on the management of government expenditures, the publication *Where Your Tax Dollars Go* will soon be available. To request a copy of this or other documentation, write or telephone: Distribution Centre, Department of Finance, Ottawa, K1A 0G5, tel. (613) 995-2855.

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91-07 The Department of Finance September 1991

Federal support for the Canada Assistance Plan (CAP)

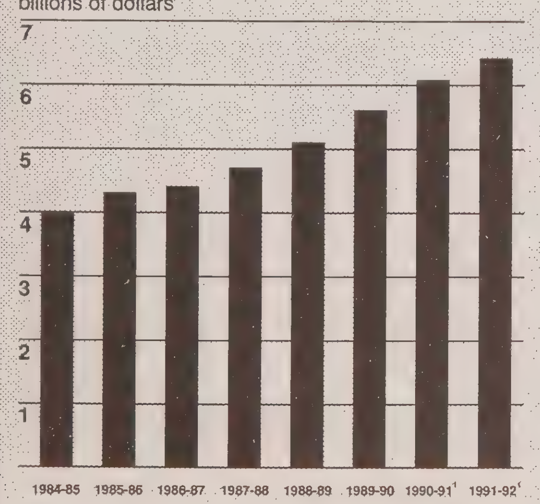
In the 1990 and 1991 budgets, the government announced wide-ranging expenditure control measures to reduce the deficit and control the growth of our $400-billion national debt. As one part of this fiscal restraint plan, the government set a 5-per-cent limit on the growth of federal contributions under the Canada Assistance Plan (CAP) to the three richest provinces, Ontario, Alberta and British Columbia. This ceiling will apply for five years, through 1994-95.

Contributions to CAP will continue to grow

The limits on CAP contributions do not put the welfare system at risk.

The federal government's support for provincial social assistance spending will continue to grow in **all** provinces. This year, the federal contributions will be about $6.4 billion.

Growth in federal CAP cash contributions



[1]Estimated provincial entitlements.

For seven provinces, no growth ceiling on federal contributions applies: the government will match all eligible provincial spending on social assistance and services, dollar for dollar.

For the three richest provinces, federal CAP contributions will also continue to grow, but to a limit of 5 per cent each year.

During the five-year period when the ceiling will be in place, total federal CAP contributions are expected to grow at an average rate of over 5 per cent a year. By comparison, growth in total federal program spending between 1992-93 and 1995-96 will be held to just 3 per cent – well below the CAP growth.

Transfer restraint needed to help solve debt problem

For decades, the federal government has provided large and growing financial support to the provinces.

These transfers are simply too large to exempt from the federal commitment to bringing our national debt under control. The government cannot be a good financial steward – on behalf of Canadian taxpayers – if such transfers were allowed to grow without any restraint.

- This year, total federal transfers to the provinces (in cash and tax points) will be

about $37 billion – up from $25.6 billion in 1984-85. That's an annual growth rate of about 5.5 per cent.

- Total federal program spending grew an average of 3.7 per cent a year from 1984-85 to 1990-91.
- Over the same period, the growth rate of federal CAP contributions has been even higher: over 7 per cent a year. For Ontario alone, CAP contributions have grown more than 13 per cent a year on average, even with the limit in 1990-91.

Federal debt load higher than total for all provinces

The federal government is more in debt than all of the provinces combined, and the interest charges on its debt last year were triple those faced by provincial governments. We can't continue spending – worsening our deficit and debt – as if this were not the case.

- The federal deficit last year was $30.5 billion. The combined deficits of all the provinces amounted to just $9.4 billion.
- The national debt this year is expected to reach $418 billion, equal to nearly 60 per cent of Canada's annual economic output. Interest payments on this debt will be about $43 billion, or more than 33 cents of every dollar of federal revenue.
- In contrast, provincial debt will be about $113 billion this year – or 16 per cent of GDP. And provincial debt payments will be $14.3 billion – about 11 cents for every provincial revenue dollar (11.6 cents in Ontario; 8.3 cents in Alberta, and 4.0 cents in British Columbia).
- By slowing the growth of CAP transfer payments to the strongest provinces, the federal government is seeking to live within its means – and the means of taxpayers – while still ensuring that Canadians in need are protected.
- Such discipline by all levels of government will help further reduce inflation and interest rates, generating the new jobs and renewed prosperity that will make it possible for governments to maintain the strong social safety net now in place.

Impact of the CAP limits

To date, the effect of the CAP ceilings on the three provinces affected has varied, depending on their spending.

- For Alberta, social assistance spending increased less than the 5-per-cent limit in 1990-91. This means that federal contributions have matched the growth in provincial spending on a dollar-for-dollar basis.
- For British Columbia, it is estimated that the province will be entitled to about $50 million less in federal CAP contributions for 1990-91 than it would receive if there were no growth ceiling.
- For Ontario, it is estimated that the province will be entitled to about $450 million less in federal contributions for 1990-91 than would be the case without the 5-per-cent CAP limit.
- *Remember:* even with the CAP ceilings, federal transfers under CAP to the three richest provinces are continuing to grow.

Annual estimated federal CAP contributions

	1990-91	1991-92
	(in millions of dollars)	
Ontario	2,000	2,100
British Columbia	715	755
Alberta	530	565
All provinces	6,075	6,400

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Economic Indicators: An International Comparison

1990 Growth in Real GDP/GNP

With the impact of the recession, growth of the Canadian GDP in 1990 lagged all other G-7 major industrial nations except the U.K. However, it is important to note that for the entire period of 1983-90, Canada's average yearly economic growth has still exceeded every other major nation except Japan. Figures are from the 1991 budget and the Economic Outlook released by the OECD in July.

	1983-90	1990
	(per cent)	
Canada	3.7	0.5
U.S.	3.5	0.9
Japan	4.5	5.6
Germany	2.8	4.5
France	2.5	2.8
Italy	2.7	2.0
U.K.	3.0	0.6

CPI Inflation

Inflation, here measured in terms of consumer prices, is a major source of pressure on interest rates. Among the major G-7 industrial countries, Canada's inflation performance has consistently been in the bottom half.

Consumer Price Index

	1989	1990	July 1991
	(per cent increase)		
Canada	5.0	4.8	5.8*
U.S.	4.8	5.4	4.4
Japan	2.3	3.1	3.9
Germany	2.8	2.7	4.4
France	3.5	3.4	3.4
Italy	6.6	6.1	6.7
U.K.	7.8	9.5	5.5

*Rate includes one-time GST impact.

Real Interest Rates

The real interest rate is the difference between the nominal (stated) rate and the rate of inflation. While average Canadian rates for 1990 were considerably higher than most other G-7 nations, their continuing decline over the last year has now brought them to levels below several of our major competitors.

Short Term

	1990	July 1991
	(per cent)	
Canada	8.2	4.4*
U.S.	2.7	1.7
Japan	4.7	3.5
Germany	5.8	4.9
France	6.8	6.2
Italy	5.6	4.7
U.K.	5.3	5.6

*Nominal rate minus CPI inflation rate excluding GST.

Long Term

	1990	July 1991
	(per cent)	
Canada	6.1	5.8*
U.S.	3.2	3.8
Japan	4.3	3.5**
Germany	6.2	5.0**
France	7.0	6.3
Italy	5.4	2.6**
U.K.	1.6	4.6

*Nominal rate minus CPI inflation rate excluding GST.
**June figures.

Comparative Tax Burdens

Figures from the OECD for 1989 (the latest comparison available) show that total Canadian tax revenues for all levels of government were lower – as a share of the economy – than in 14 of the 24 nations surveyed.

Among G-7 nations, only Japan and the U.S., which do not have our level of government funding for health and post-secondary education, had lower ratios of total taxation to GDP.

1989 Total Tax Burdens
(per cent of GDP/GNP)

Canada	35.3
U.S.	30.1
Japan	30.6
Germany	38.1
France	43.8
Italy	37.8
U.K.	36.5

In terms of corporate income tax, the OECD figures show again that Canadian tax revenues – as a share of our economy – were lower than for several G-7 nations.

1989 Corporate Taxation
(per cent of GDP/GNP)

Canada	3.0
U.S.	2.6
Japan	7.5
Germany	2.1
France	2.4
Italy	3.8
U.K.	4.5

Fiscal Situation

As a share of our economy, Canada's federal deficit – on a comparable national accounts basis – was the second highest among the G-7 nations.

However, this represents a significant improvement since 1984, when the federal deficit equalled 6.8 per cent of GDP, double the current level. In fact, between 1984 and 1990, the Canadian deficit has declined more rapidly than for the G-7 average.

1990 Central Government Deficits
(per cent of GDP/GNP)

Canada	3.4
U.S.	3.0
Japan	1.2
Germany	2.3
France	1.4
Italy	9.5
U.K.	0.1

It is also important to note that under a different accounting convention, Canada's deficit is actually proportionately smaller than the American deficit. On the basis of financial requirements by the Canadian government, our deficit represented 3.5 per cent of GDP in fiscal 1990: the comparable unified budget balance in the U.S. for fiscal 1990 was equal to 5.7 per cent of GNP.

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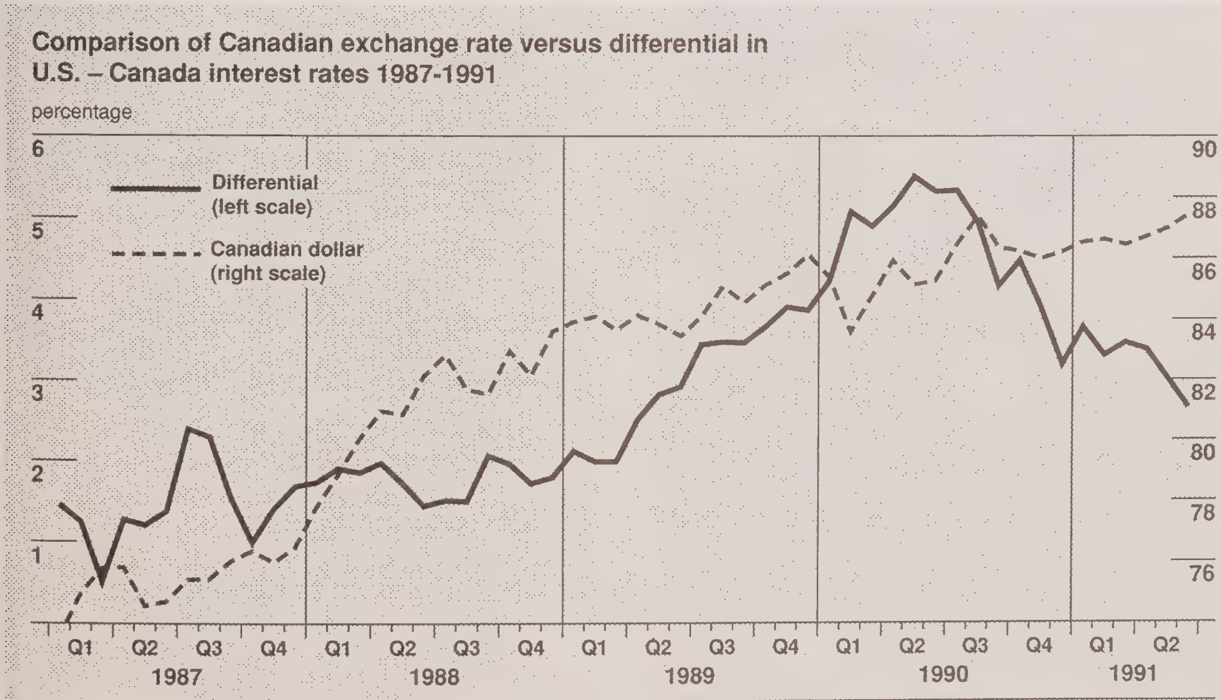
Facts about the Canadian dollar exchange rate

The value of the dollar is strong against both American and most overseas currencies. This adds to the cost of Canadian goods compared to those from other countries – making it more difficult for our firms to compete in export markets and against imports. Many Canadians are worried by this situation, and want to know why the exchange rate has moved up.

Interest rates not causing the dollar's current rise

Many factors, including interest rates, can affect the relative value of our dollar. However, it is clear that Canadian interest rates are **not** the reason for the increase in the exchange rate over the last year.

- In May last year, short-term Canadian interest rates were 565 basis points higher than U.S. rates. And the exchange rate for our dollar averaged 84.6 cents U.S.



This chart tracks the value of the Canadian dollar in U.S. funds (dotted line) against the narrowing gap between the interest rate for 90-day commercial borrowing (solid line) in recent years.

- Since then, Canadian interest rates have fallen sharply: more than five percentage points. This has cut the difference between Canadian and U.S. rates by half, to 280 basis points. Yet the dollar has moved higher – to 88 cents U.S. by mid-September (see chart).
- Canadian interest rates do not account for the increase in the dollar against many other foreign currencies. Among the G-7 countries, only the U.S and Japan now have lower short-term interest rates than Canada.

Several factors pushing Canadian dollar higher

There are a number of near-term factors which have increased demand for the Canadian dollar, pushing it higher against other currencies.

Provincial borrowing

- In the first half of 1991, provincial governments placed $10.9 billion in new debt issues – government borrowing – in foreign financial markets. This is double the amount placed in all of 1990.
- This rapid pace of foreign borrowing by the provinces is continuing, putting upward pressure on the dollar. This is why the federal government has stressed the importance of fiscal restraint – living within our means – for all levels of government.

International uncertainty

- Political uncertainty in the Soviet Union, the Middle East and elsewhere has meant an increased demand for "safe haven" currencies. This has produced a large shift by European and Asian investors to North American securities.
- Given Canada's size, even relatively small shifts in favour of Canadian-dollar securities can have large impacts on our currency.

Risk of inflation

Financial markets may have over-estimated inflation pressures in Canada.

- The one-time impact of the GST and some provincial sales taxes pushed up the year-over-year consumer price index to 6.8 per cent in January.
- If financial markets speculate that inflation pressure could stop interest rates from falling further – or even cause them to rise – it increases the incentive to buy Canadian funds, and this demand pushes the dollar higher.

But inflation pressures in Canada are declining significantly. This is providing room for further easing in interest rates as inflation subsides.

- Year-over-year inflation rates have now declined to 5.8 per cent – and they still carry the baggage of past price level adjustments which camouflages the improvement in the underlying inflation rate. But over the last four months, for example, the annualized three-month rate of inflation in Canada is running at just 3.1 per cent.
- Wage pressures are declining. In July, private-sector settlements were 3.6 per cent, while government-sector wage increases averaged 2 per cent.

The dollar in perspective

- **Over the last 40 years, the Canadian dollar has averaged 92.6 cents U.S.**
- The exception was the 1976-86 period, when the dollar plunged after we let our industrial costs increase substantially out of line with those in the U.S.
- **A lower dollar doesn't necessarily mean increased competitiveness for Canadian firms except in a very temporary way.**
- Overall, it is improved productivity and our ability to control costs that determines how well we compete in a global marketplace. And we have done poorly during the 1980s compared to most major industrial nations.
- For example, even though the Canadian dollar fell sharply from 1976 to 1986, our domestic unit labour costs grew faster than those in the U.S. As a result, in the highly competitive manufacturing sector, our unit cost position deteriorated 27 per cent over this period.

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Canadian Tax Facts

Canada's tax system – how we are taxed, and how much we are taxed – is one of the most visible aspects of government, and often one of the most controversial. It affects our personal finances, and how well our economy functions in providing investment, growth and jobs. It determines the capacity of government to fund vital public programs – such as health care – and to support those among us who need assistance.

Since coming to office in 1984, the government has implemented major reforms to Canada's federal tax system. These have increased the fairness and progressivity of the federal system and eliminated economic distortions, while ensuring we remain competitive in today's global marketplace.

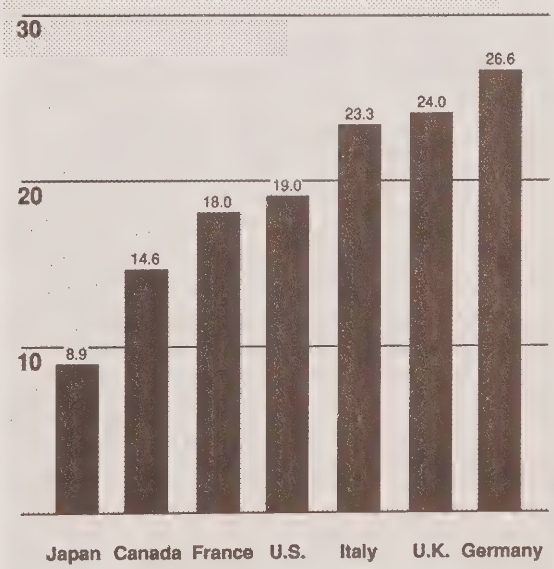
Canadians Benefit From Lower Rates of Personal Taxation

Canada is sometimes identified as having the highest level of personal income taxation among G-7 nations. However, this ignores the fact that other G-7 nations make much greater use of social security taxes which are also paid by individuals.

In Canada, the combination of personal income taxes and social security contributions produced tax revenues estimated at just over 18 per cent of GDP in 1989. That was a lower level than in the U.S. (19.5 per cent), Italy, Germany and France among the G-7 nations.

According to an OECD study, the average Canadian production worker paid less in income tax – federal and provincial – and social security contributions in 1989 than the workers in 18 other nations. This included the U.S. and every other G-7 nation except Japan.

Taxation of average production worker[1]
One-earner couple with two children



[1] Income tax and employee's social security contributions as a percentage of 1989 gross earnings.

Total Taxation is Lower Than in Many Major Nations

Canada's total tax revenues – federal, provincial and local – are equal to about one-third of our total economic output (gross domestic product). Compared to other G-7 nations, this is less than for France, Germany, Italy and the United Kingdom.

Among the 24 nations of the OECD, Canada ranks in the bottom half in terms of its national tax burden.

Federal Budgetary Revenues at Same Level as Early 1970s

For 1990-91, federal budgetary revenues were equal to 17.8 per cent of GDP. While this represents an increase over 1984-85, it is virtually the same level as existed between 1969-70 and 1973-74, when federal budgetary revenues averaged 17.3 per cent of the economy.

Increased tax revenues have helped reduce the federal deficit from 8.7 per cent of GDP in 1984-85, to 4.5 per cent. However, the major share of this improvement in Canada's fiscal situation was due to restraint of program spending.

Canada's Tax System Now Fairer, More Progressive

As a result of tax reform and the Alternative Minimum Tax, more high-income Canadians are paying tax than ever before. The percentage of individuals earning over $100,000 but paying no tax fell from 2.2 per cent in 1984 to just 0.35 per cent in 1988.

The share of the total personal income tax burden paid by those earning less than $15,000 a year has been reduced by almost two-thirds – from 2.1 per cent of all income taxes in 1987, to just 0.8 per cent in 1988. The share for those earning over $100,000 increased from 13.7 per cent to 16.7 per cent.

Distribution of personal income tax burden

Total income	1987 share of tax	1988 share of tax
(dollars)	(per cent)	
Less than 15,000	2.1	0.8
15,000 – 30,000	26.5	23.1
30,000 – 50,000	37.3	35.7
50,000 – 100,000	20.4	23.7
100,000 and over	13.7	16.7

The number of seniors relieved of paying income tax jumped by almost 300,000 between 1987 and 1988. This represented an increase of 43.2 per cent in the number of seniors not paying tax.

Corporations Are Now Paying Fairer Share of Tax Burden

Tax reform eliminated many of the loopholes that allowed large numbers of profitable corporations to avoid paying any corporate income tax. These reforms and the introduction of the Large Corporations Tax mean that federal corporate income tax revenues in 1990-91 were 60 per cent higher than in 1983-84, despite the fact that corporate profits last year were 10 per cent lower than in 1984.

A Better Sales Tax System

The introduction of the GST to replace the hidden Manufacturers' Sales Tax (MST) represents a significant improvement in Canada's tax system. By eliminating sales tax on business inputs, the GST will stimulate investment and strengthen the ability of Canadian firms and workers to compete in our home market and abroad.

The GST is also a more stable and secure source of revenue to ensure the government can make further progress in reducing the federal deficit. As promised in the 1991 budget, legislation has been introduced to ensure that GST revenues go only to a Debt Servicing and Reduction Account, and are not used for other things.

As part of the GST, a tax credit is now being paid on a quarterly basis to low- and modest-income Canadians. The credit is designed to ensure that lower-income Canadians will pay less sales tax than they did with the MST, improving the fairness of our national tax system.

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Canadian federalism and economic union: Highlights of proposals

Proposals for the renewal of the Canadian federation have been put forward by the Government of Canada for public discussion and study by a Special Joint Parliamentary Committee. A number of these proposals are designed to strengthen Canadian economic union. Following is a brief summary of these proposals.

Introduction

The proposals reflect the reality that Canadian unity and prosperity – and a more successful political and economic union – go hand in hand.

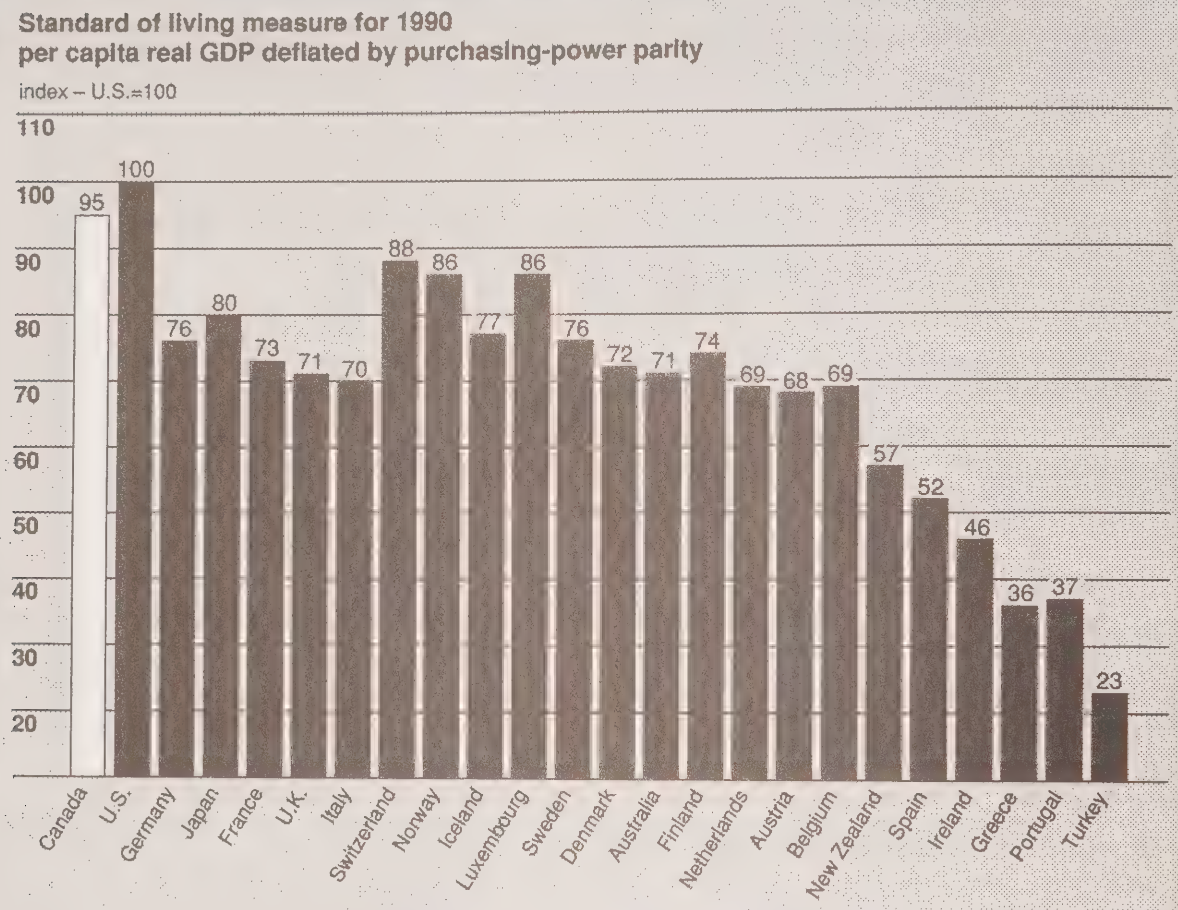
- Federalism has worked well for Canadians, helping to achieve the world's second highest standard of living.
- However, serious internal economic barriers are preventing us from reaching our full economic potential. They are damaging the effort to preserve and strengthen Canada's living standards and public services in the face of a more competitive and rapidly changing international marketplace.

Proposals have been made to strengthen Canadian economic union in several important areas:

- to eliminate barriers to the free flow of persons, goods, services and capital in Canada's internal market;
- to provide a new co-operative framework for Parliament, with the agreement of the provinces, to pass legislation for the efficient functioning of the economic union;
- to reduce overlap and duplication in federal and provincial roles in the financial sector;
- to improve coordination of macroeconomic policy among the federal and provincial governments and to promote the harmonization of fiscal policies with monetary policy;
- to make clear that the mandate of the Bank of Canada is to achieve and preserve price stability consistent with other Canadian economic objectives; and to ensure more effective input of information on regional economic conditions in the setting of national monetary policy.

Eliminating barriers

A strengthened common market clause in the Constitution (Section 121) would allow



Source: OECD, *Main Economic Indicators*, March 1991.

Purchasing-power parity (PPP) is defined by the OECD as "the rates of currency conversion that equalize the purchasing power of different currencies". This means that a given sum of money, when converted into different currencies at the PPP rates, will buy the same basket of goods and services in all countries.

the courts to strike down programs or practices of the federal or provincial governments that constitute barriers or restrictions to the mobility of persons, goods, services or capital in the internal market.

- Exceptions would be provided for reasons of national interest and the provision would not apply to legislation promoting regional development or equalization.
- This clause would come into effect July 1, 1995 to provide time for the federal and provincial governments to work together to eliminate as wide a range of restrictions as possible.

Efficient economic union

In order to promote co-operative approaches to economic policy, a new power would be provided for Parliament to pass legislation for the efficient functioning of the economic union, subject to:

- approval of at least seven of the provinces representing at least 50 per cent of the population; and
- the right of dissenting provinces to opt out for a three-year period providing 60 per cent of the members of the provincial legislative assembly approve such a resolution.

- The Special Joint Parliamentary Committee will consider whether, and in what circumstances, this opting-out provision should be renewable.

Financial sector regulation

Proposals address the need for governments to work together to deal with costly and inefficient overlap and duplication in financial sector regulation.

The Government of Canada will work actively with the provinces to clarify responsibilities in the regulation of trust companies, which currently can face as many as 10 or 11 regulatory regimes in the Canadian market.

- The federal government is prepared to explore with the provinces the possibility of moving toward a regulatory regime based on lead jurisdiction or mutual recognition.
- For federally incorporated trust companies, such arrangement could be achieved by provinces delegating their administrative or regulatory power to the federal government.

The Government will also work closely with the provinces to develop more efficient and better co-ordinated securities regulation which will be essential to the international competitiveness of our securities markets.

- A key goal is to ensure a more effective presence for Canada in international securities regulatory matters.

Policy co-ordination

Proposals seek to develop, in co-operation with the provinces, better co-ordination of fiscal policies and better harmonization of fiscal and monetary policy through a number of avenues:

- More open, co-operative budgetary processes including:
  - a relatively fixed annual budget cycle, with a fixed annual schedule of Finance Ministers' meetings, including regular sessions with the Governor of the Bank of Canada;
  - publication by the 11 governments of pre-budget economic and fiscal outlooks;
  - common accounting conventions.
- An independent agency to monitor and evaluate federal and provincial macroeconomic policies:
  - The agency would be similar to those operating in other countries, allowing for greater public debate on the issues and input into the policy formulation process through regular meetings with the Finance Ministers;
  - It would issue regular public reports on Canadian macroeconomic policies and act as a public interpreter on how well year-to-year policies mesh with longer-term objectives;
- Agreement on guidelines, developed with the provinces, for the conduct of fiscal policy in a medium to longer-term context.

Monetary policy

Proposals seek to improve the transparency of Canadian monetary policy by clarifying the Bank of Canada's mandate and ensuring greater Bank sensitivity to regional concerns by:

- amending the *Bank of Canada Act* to make clear that the mandate of the Bank is to achieve and preserve price stability, while conducting monetary policy with due cognizance of the path to price stability that best contributes to other Canadian economic objectives;

- soliciting provincial government views on appointments to the Board of Directors of the Bank of Canada;
- creating regional consultative panels to advise the Directors;
- making the appointment of the Governor of the Bank of Canada subject to Senate ratification;
- requiring that the Governor testify semi-annually before Parliament on financial and economic conditions and the intended course of monetary policy in the upcoming year, in addition to meeting Finance Ministers as part of the budget process.

Further information on these proposals is contained in the publication, *Canadian Federalism and Economic Union, Partnership for Prosperity.* Copies can be obtained through the Distribution Centre, Department of Finance, Ottawa, K1A OG5, tel. (613) 995-2855.

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Facts about corporate taxes

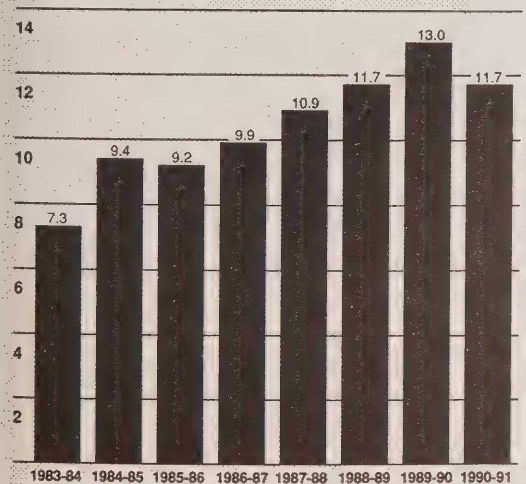
Some Canadians are concerned that our country's business corporations are not paying a fair share of our national tax burden. They wonder why corporate taxes today represent a lower share of government revenues than 10 or 20 years ago. The following facts should help set the record straight concerning corporate taxation.

Corporate income taxes grew 60 per cent since 1983-84

Federal revenues from corporate income taxes were about 60 per cent **higher** in the 1990-91 fiscal year than in 1983-84 – even though corporate profits last year were about 10 per cent **lower** than seven years ago.

Federal corporate income tax revenues

billions of dollars



Because corporate tax revenues are linked to the level of corporate profits, they tend to rise or fall depending on the health of the economy. When corporate profits decline, business' income tax payments typically also fall – as they did between 1989-90 and 1990-91.

Corporate profits, 1984-90

billions of dollars

1984	42.3
1985	46.7
1986	43.2
1987	53.9
1988	61.2
1989	54.6
1990	37.9

This is why it should not be surprising that federal revenues from corporate income taxes have grown only about half as much as revenues from personal income taxes. While corporate profits have been relatively stagnant – growing slowly in some years and falling in others – personal incomes on a national basis have increased consistently, so that in 1990 they were up by about 60 per cent (or $218 billion) over 1984.

International comparison of corporate tax burden

Tax rates can directly affect investment, production and employment decisions by business. Canada could not maintain a competitive economy and create jobs if corporate taxes were substantially out of line with those in other major industrial countries.

According to OECD figures, Canadian corporate income taxes in 1989 were equal to 3 per cent of our economy. This placed Canada in the middle among G-7 nations.

1989 Corporate taxation
per cent of GDP/GNP

Canada	3.0
U.S.	2.6
Japan	7.5
Germany	2.1
France	2.4
Italy	3.8
U.K.	4.5

Corporate taxes today do represent a smaller share of total Canadian tax revenues than 20 years ago. This is true in many industrialized countries. Among the G-7 countries, only Italy collects more from corporate taxes today – as a percentage of all taxation – than in 1970.

Reforms have increased fairness of tax system

The fact that corporate tax revenues remain relatively strong despite lower business profits highlights the impact of government reforms to the tax system.

Starting in 1988, the reforms broadened the corporate tax base by reducing or eliminating many tax incentives and loopholes. These measures have increased tax revenues by an estimated $1 billion annually. They have also significantly reduced the number of profitable corporations which did not pay tax.

In 1989, the government also introduced the Large Corporations Tax to ensure the corporate sector contributes its fair share to deficit reduction. The tax ensures that all large corporations pay tax, and adds some $1 billion in federal tax revenues.

In particular, tax reform has had a major impact on banks, which benefited from low tax levels under the previous system. In 1989, however, banks paid over $1 billion in federal corporate taxes.

As part of tax reform, Canada has also reduced its federal corporate income tax rate from 46 per cent to 38 per cent – a measure in line with the reduction in U.S. corporate rates to 34 per cent. However, because Canadian tax reform also broadened the tax "base" – by eliminating loopholes and special tax preferences – corporate tax revenues are still higher than they were previously.

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Canadian federalism and economic union: Questions and answers

Why has the government introduced economic union proposals into the unity debate?

A strong economic union is essential for both the prosperity and the unity of Canada.

Economic and unity issues are closely linked. Canada's economic union was established by the constitution of 1867 that created the Canadian federation. Our economic union has helped Canadians achieve the world's second highest standard of living, but we cannot take our prosperity for granted in today's highly competitive and rapidly changing world economy.

As other countries join forces to do away with economic barriers, Canada risks falling behind if we allow our economy to become fragmented internally. In such an economy we would find it more difficult to compete internationally and create new wealth and jobs. We would also find it more difficult to maintain the public services and programs that have helped to build and define Canada. Our economic prosperity and national unity go hand in hand.

Canadians have made clear that they want government to give high priority to economic issues. The economic union proposals respond to that concern.

Don't the federal government's proposals really amount to a "power grab" at the expense of the provinces?

The proposals give the federal government no new powers whatsoever at the expense of the provinces.

To say the federal government is making a "power grab" is a complete misunderstanding of the proposals. Their whole thrust is to equip the federal and provincial governments to work co-operatively together, rather than at cross purposes, to increase the economic well-being of Canadians.

The federal government has proposed two constitutional amendments to strengthen our economic union, along with some other new approaches to permit greater co-ordination and harmonization in economic policy-making between the federal and provincial governments.

- First, to ensure **the free flow of persons, goods, services and capital** within Canada, the government proposes an amendment to the "common market clause" (section 121 of the *Constitution Act, 1867*) that would remove barriers to such mobility.

- Second, to **streamline the process of joint decision-making by the federal and provincial governments** in cases where greater co-ordination would help to

strengthen the economic union, the government proposes to add a new provision to section 91 of the Constitution Act.

The proposals would give the two levels of government new power *to act together*. They would give the federal government no new power *to act by itself.*

How serious are these economic barriers?

In today's competitive world, the cost of internal barriers to economic growth can be very high indeed.

Canada is now a very different country, and the world a different place, than it was in 1867, when the Canadian Confederation was formed to secure the benefits of political and economic union. Canadians have taken an economy once based almost entirely on natural resources and transformed it into a modern industrial economy, the seventh largest in the world.

But many of our constitutional and other governmental arrangements were not designed for Canada of the 21st century.

For example, the "common market clause" in our constitution dates back to 1867. It calls for goods from any one province to be admitted free of tariffs into the others. But it doesn't mention barriers other than tariffs. Nor does it mention capital or services, and it says nothing about the mobility of people – a basic right of all Canadians.

Our abilities as Canadians to take advantage of economic opportunities in any part of the country – to work, to invest our savings, to sell our goods and services – is critical to our economic well-being. It should be remembered, for example, that Alberta, Manitoba, Nova Scotia, Prince Edward Island and Quebec are all more dependent on interprovincial than on international trade.

A strengthened economic union will help to ensure stronger growth and better jobs. More importantly, it will guarantee equality of competitive opportunity for all Canadians and for all Canadian firms across the country.

Why has the problem only come up now?

This is a longstanding problem – but now there is widespread recognition that action to strengthen Canada's economic union can no longer be put off.

Federal and provincial governments have been talking about the need to modernize and strengthen the Canadian economic union for most of the last 30 years, with little to show for it.

- In 1979, the Ontario government proposed that the free movement of people, capital, goods and information within Canada should be constitutionally guaranteed.
- In 1980, the Quebec Liberal party proposed constitutional measures to guarantee the rights of Canadians to settle anywhere in the country and to ensure the free circulation of goods and capital.
- Since 1987, at the request of the First Ministers, an Intergovernmental Committee of Ministers on Internal Trade has sought agreement on reducing internal barriers in selected priority areas – government procurement, beer marketing and wine and spirits.
- In 1990, the Quebec Liberal party's Allaire report called for a stronger economic union: "The definition of a new economic framework for Quebec and Canada must reflect the initial objective of the Fathers of Confederation, that is, the creation of a true common market that is highly integrated economically . . . . A stronger Canadian common market is one of Quebec's prime objectives."

How would the "free flow" proposal work?

Canadians would have the right to challenge restrictive government practices in the courts.

Under the proposed amendment to the "common market clause", Canadians would be empowered to go to court to challenge government practices– federal or provincial – that restrict the free flow of persons, goods, capital or services within Canada on the basis of provincial boundaries.

This new provision would give no new power to either the federal government or the provincial governments. It would, rather, give Canadians a right similar to the right of American citizens, under the United States Constitution, to go to court to strike down barriers to interstate commerce.

The federal government believes this amendment would help to remove a variety of barriers – from the banning of interprovincial beer sales to government procurement policies that discriminate against out-of-province suppliers. Some estimates say such barriers cost Canada's economy as much as $6 billion a year. They reduce competition, increase the cost of doing business and result in higher prices or taxes – in short, they reduce our standard of living.

What would happen to regional development programs?

Nothing in the proposals would interfere with regional development programs.

A stronger economic union would benefit all regions of Canada. The federal government's proposal nonetheless recognizes that some exceptions to the "free flow" amendment would be justified. It would therefore not apply to legislation promoting regional development or equalization, or to policies declared by the federal government and seven provinces with 50 per cent of the population to be in the "national interest."

In addition, to allow time for the federal and provincial governments to work together to eliminate as wide a range of restrictions as possible, the government proposes that the new clause not come into effect until July 1, 1995.

How would the "joint decision-making" proposal work?

Parliament could legislate to improve management of the economic union, but only if the provinces agree.

Under the proposed amendment to section 91, the Canadian Parliament would be empowered to make laws for the efficient functioning of the economic union. Such laws, however, would become effective only if approved by at least seven provincial governments representing at least 50 per cent of Canada's population. In addition, any province wishing to opt out of such legislation could do so for three years. The Special Joint Committee on constitutional proposals will consider whether this opting out provision should be renewable.

It is important to understand that this is in no sense a power that the federal government could use to interfere in provincial economic affairs. Indeed, it is not a power that the federal government could in any way use on its own.

The application of this new power would thus be strictly limited to co-operative measures to improve the management of Canada's economic union. It would provide a mechanism to facilitate co-operation, for example, in establishing standards for skilled trades that would be recognized across the country, or in harmonizing environmental standards.

This new mechanism could also be a useful way, if federal-provincial agreement exists, for governments to improve co-ordination of fiscal policies or to reduce overlap and duplication in the regulation of financial institutions.

Does the federal government want to dictate provincial fiscal and economic policies?

The federal government is seeking to create a more open, accessible and co-operative policy-making process – exactly the opposite of a dictatorial approach.

Because the provinces collectively spend more than the federal government, there is a need to co-ordinate budgets so that they do not work at cross-purposes with each other and with the Bank of Canada in the effort to achieve lower interest rates, improved employment prospects and higher incomes for Canadians. For this reason, the government proposes to develop, with the provinces, an open process to improve the co-ordination of fiscal policies and the harmonization of fiscal policies with Canada's monetary policy. This process could include guidelines, should governments and the public find such guidelines useful. One such guideline, for example, might be a consensus that budgets should be balanced over the full course of a business cycle.

The key to a more open process is a fixed annual timetable to allow for more accessible and visible federal and provincial budget-making processes. This would include a relatively fixed annual budget cycle, a fixed annual schedule of finance ministers' meetings, the publication by all 11 governments of pre-budget economic and fiscal outlooks and the adoption of common accounting conventions. An independent monitoring agency and a greater role for parliamentary committees would assist the public to get involved in the budget-making process.

The purpose of these innovations would be not to dictate policies, but to develop common viewpoints. The government believes that a more open, co-operative process will lead to better policies.

Is the government open to other proposals on how to achieve the same goals?

The government is open to any suggestions that will improve the proposals.

As was made clear when the government's constitutional proposals were released, they represent an invitation to all Canadians to participate in the renewal of Canada.

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Price stability

In recent years, the federal government and the Bank of Canada have emphasized the importance of directing monetary policy at containing and reducing inflation, and moving toward price stability. Achieving price stability is the most important contribution that monetary policy can make to ensuring that the economy realizes its full potential. This is the only way to secure lower interest rates, support strong, sustainable growth, and avoid the distortions inflation causes in the distribution of income – in particular the erosion of living standards of those on fixed income.

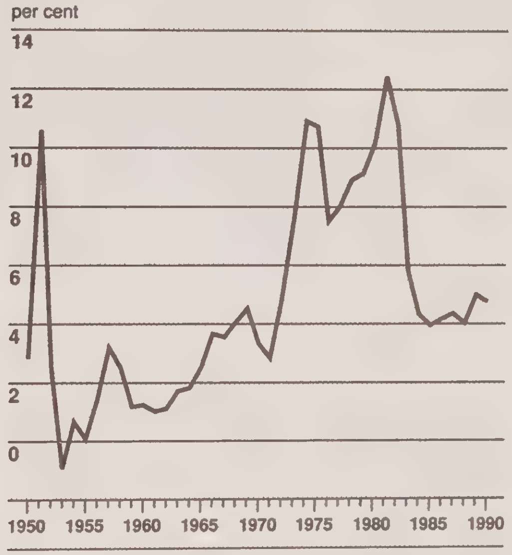
What is price stability?

Price stability means there would be no *ongoing increases* in the average price level of all goods and services in the economy. In other words, there would be no ongoing erosion of people's purchasing power due to inflation.

Because of complications in measuring inflation, it is not possible, at this time, to define price stability as a single, precise numerical target for inflation. In terms of the consumer price index (CPI), the most widely used and understood measure of the general price level, measured inflation of clearly less than 2 per cent is consistent with price stability.

Canada has been able to achieve measured rates of inflation of less than 2 per cent on a continuing basis. From the end of the Korean War until 1960, annual inflation averaged 1.2 per cent. Inflation only began to gather momentum in the latter part of the 1960s and then got much worse in the 1970s (Chart 1).

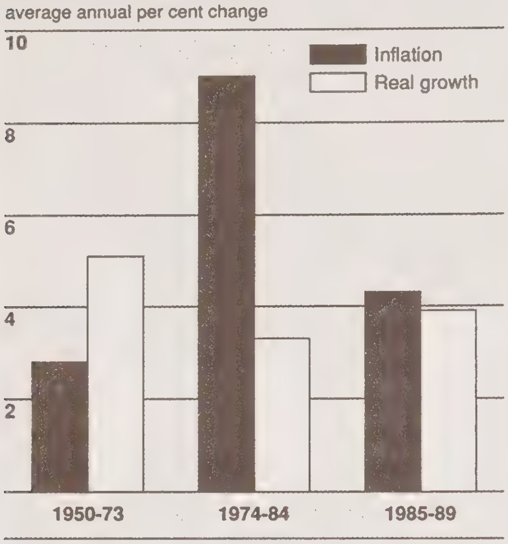
Chart 1
CPI inflation in Canada



Why price stability?

It is widely recognized now that in the long run, higher economic growth cannot be achieved by accepting higher inflation. Price stability will make a significant contribution to improving our economic performance and raising our living standards. This will be achieved through eliminating the destructive effects of inflation on growth, productivity, competitiveness and income distribution. The costs of not achieving and maintaining price stability are readily evident in Canada's recent economic performance.

Chart 2
Inflation and real growth in Canada
Selected periods



With the intensification of inflation in the 1970s, Canadian economic growth and productivity growth slowed and standards of living rose less quickly compared to the early postwar period of low and stable inflation (Chart 2).

Inflation hampers efficiency and productivity by causing scarce resources to be diverted away from productive activities to inflation-hedging and inflation-shielding activities. For example, inflation shortens contract lengths, resulting in resources being diverted to more frequent negotiation of contracts.

Further, failure to eradicate inflation in recent years has been at the root of the boom-and-bust cycles in Canada. Inflation in the 1970s was allowed to continue rising until checked or lowered by an inevitable downturn, only to rise again from its higher base. Expectations of higher inflation became firmly entrenched, with each failure to fully deal with inflation.

This pattern continued until 1981, when the most severe recession in Canada's postwar history pushed inflation down from over 12 per cent to the 4 to 5 per cent range. Similarly, the most recent recession reflects the need to contain and reduce the inflation pressures built up over the 1983-1989 expansion.

Inflation has also contributed to higher interest rates as lenders have demanded a premium to compensate for the erosion of the real value of their capital as inflation rises. In turn, it has raised the cost of capital, both because of its impact on interest rates and because of the premium for uncertainty that high inflation causes. These higher capital costs damage Canada's international competitiveness and reduce potential growth.

Finally, inflation has arbitrarily and unfairly redistributed income. It hurts people on fixed incomes most by reducing their purchasing power. At an inflation rate of 5 per cent, for example, the purchasing power of a fixed stream of income, such as a pension, is halved in 14 years.

In summary, the best contribution that monetary policy can make to economic performance over the long term is to preserve the purchasing power of the nation's money.

Canada is not alone in emphasizing price stability

Price stability is the key objective underlying monetary policy in a number of industrialized countries.

Its importance is reflected in the communiqué issued by leaders of the G-7 countries from the 1991 London Summit:

- "Our shared objectives are a sustained recovery and price stability."

The importance of price stability as the primary objective of monetary policy has been explicitly recognized in the United States. As

Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve has stated,

- "Fundamentally, our strategy continues to be centered on moving toward, and ultimately reaching, stable prices, that is, price levels sufficiently stable so that expectations of change do not become major factors in key economic decisions."

In establishing the objectives for the future European central bank, which will comprise the Member States' central banks in the European Monetary Union and have sole responsibility for monetary policy, price stability is recognized as the prime objective of monetary policy. It is strongly supported by the majority of Members, even those countries that have historically been inflation-prone.

Price stability and the Bank of Canada's mandate

Modernizing and clarifying the Bank of Canada's mandate to focus on price stability has the support of many leading economists and research institutes. For example, in a recent C.D. Howe study, David Laidler said:

- "the target of price-level stability is both appropriate and feasible and the Bank's mandate should be updated accordingly."

The current mandate of the Bank of Canada is overly broad, ambiguous and, in the short run, some of the objectives can be in conflict. This has created confusion about the goals of monetary policy and what can be expected from it.

The government has recommended that the mandate of the Bank state that:

- "in formulating and implementing monetary policy, the Bank of Canada is to guide the pace of monetary expansion and influence monetary and credit conditions with the objective of achieving and preserving stability in the general level of prices in Canada."

This change recognizes that it will take time to achieve price stability. As well, it recognizes that the economy will, on occasion, be subject to economic shocks that could cause temporary deviations from the inflation targets or price stability. In the event of such shocks, the proposal recommends that:

- "in determining the desired path toward price stability and the appropriate pace to return to price stability following such shocks, monetary policy should be conducted with due cognizance of the path to price stability that best contributes to other Canadian economic objectives."

Further, the government makes clear that there will be a mechanism for the government and the Bank to agree on, and make public, the appropriate path to return to price stability:

- "While it is not appropriate to enshrine a specific path in the *Bank of Canada Act*, the Act would provide for a mechanism whereby the Bank of Canada and the government agree on, and make public, the desired path toward price stability."

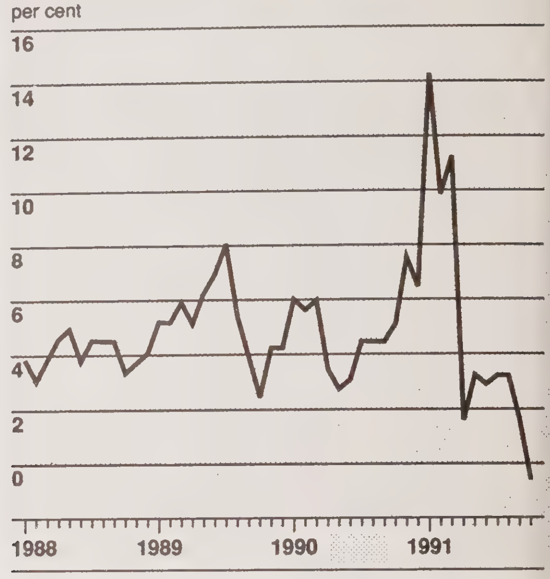
As well, the proposed changes include steps to increase the transparency of monetary policy by improving the communication of the objectives and practices of monetary policy.

Progress toward price stability

The government and the Bank of Canada jointly announced inflation-reduction targets on February 26, 1991. The targets provide for steady, gradual reductions in the rate of inflation to 3 per cent by the end of 1992 and to 2 per cent by the end of 1995. Thereafter, further progress toward price stability will be achieved.

Inflation is on track to meet the 1992 target. On a year-over-year basis, CPI inflation was 4.4 per cent in October, down from an average of 6.4 per cent in the first half of 1991. The three-month annualized inflation rate was in the 3 per cent range from May to August and fell to -0.6 per cent in October (Chart 3).

Chart 3
Three-month annualized inflation



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Facts about corporate taxes

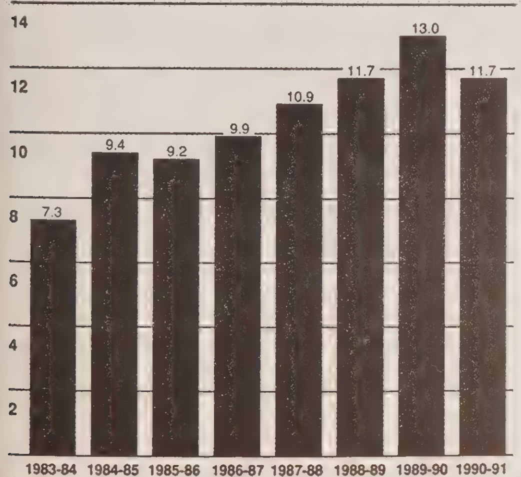
Corporate taxes today represent a lower share of government revenues than 10 or 20 years ago. Because of this, some Canadians believe that our country's business corporations are not paying a fair share of our national tax burden. The following facts should help set the record straight concerning corporate taxation.

Corporate income taxes grew 60 per cent since 1983-84

Federal revenues from corporate income taxes were about 60 per cent **higher** in the 1990-91 fiscal year than in 1983-84 – even though corporate profits last year were about 10 per cent **lower** than seven years ago.

Federal corporate income tax revenues

billions of dollars



Because corporate tax revenues are linked to the level of corporate profits, they tend to rise or fall depending on the health of the economy. When corporate profits decline, business' income tax payments typically also fall – as they did between 1989-90 and 1990-91.

Corporate profits, 1984-90

billions of dollars

1984	42.3
1985	46.7
1986	43.2
1987	53.9
1988	61.2
1989	54.6
1990	37.9

This is why it should not be surprising that federal revenues from corporate income taxes have grown only about half as much as revenues from personal income taxes. While corporate profits have been relatively stagnant – growing slowly in some years and falling in others – personal incomes on a national basis have increased consistently, so that in 1990 they were up by about 60 per cent (or $218 billion) over 1984.

International comparison of corporate tax burden

Tax rates can directly affect investment, production and employment decisions by business. Canada could not maintain a competitive economy and create jobs if corporate taxes were substantially out of line with those in other major industrial countries.

According to OECD figures, Canadian corporate income taxes in 1989 were equal to 3 per cent of our economy. This placed Canada in the middle among G-7 nations.

1989 Corporate taxation

per cent of GDP/GNP	
Canada	3.0
U.S.	2.6
Japan	7.5
Germany	2.1
France	2.4
Italy	3.8
U.K.	4.5

Reforms have increased fairness of tax system

The fact that corporate tax revenues remain relatively strong despite lower business profits highlights the impact of government reforms to the tax system.

Starting in 1988, the reforms broadened the corporate tax base by reducing or eliminating many tax incentives and loopholes.

Among the measures taken were the following:

- elimination of general investment tax credits and limitation on yearly claims by large corporations;
- reduction of capital cost allowance rates for several classes of assets;
- limitation on the deduction for business meals and entertainment expenses;
- elimination of after-tax financing arrangements using preferred shares.

In addition, the Large Corporation Tax was introduced to ensure that all large corporations pay tax; large financial corporations are also subject to a minimum tax on financial capital.

Together, these actions:

- have increased tax revenues by an estimated $2 billion annually;
- are expected to reduce the number of profitable corporations that do not pay tax by an estimated 50,000.

In particular, tax reform has had a major impact on banks, which benefited from low tax levels under the previous system. In 1989, however, banks paid over $1 billion in federal corporate taxes.

As part of tax reform, Canada has also reduced its federal corporate income tax rate from 46 per cent to 38 per cent – a measure in line with the reduction in U.S. corporate rates to 34 per cent. However, because Canadian tax reform also broadened the tax "base" – by eliminating loopholes and special tax preferences – corporate tax revenues are still higher than they were previously.

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The 1992 federal budget

The 1992 budget cuts spending to cut taxes and boost economic growth and competitiveness. It also ensures substantial declines in the deficit for 1992-93 and beyond.

Action to bolster recovery

Reducing personal income taxes

- Personal income taxes will be cut. The general personal income surtax will drop from 5 per cent of basic tax to 4 per cent on July 1, 1992 and by a further 1 per cent on January 1, 1993. This will put an additional $500 million into taxpayers' hands in the 1992-93 fiscal year, rising to more than $1.2 billion in subsequent years. All 14.6 million taxpayers will benefit.

The Home Buyers' Plan

- Individuals will be able to withdraw up to $20,000 from their registered retirement savings plans (RRSPs) tax-free to buy or build a home, and repay the amount over 15 years. This measure takes effect immediately and will apply until March 1, 1993.

Action for investment, initiative and jobs

Manufacturing and Processing

- The manufacturing and processing tax rate will be reduced from 23 to 22 per cent effective January 1, 1993, with a further one point reduction on January 1, 1994.
- The capital cost allowance rate for manufacturing and processing machinery will be increased from 25 to 30 per cent, effective for acquisitions made after budget day.
- Direct investment in all sectors will be encouraged by negotiating reciprocal agreements with trading partners to reduce the withholding tax rate on direct dividends to 5 per cent.

Research and Development

- The budget announces a commitment to enrich the tax incentives for R&D by $230 million over the next five years and to improve the system to make it more effective.

Small business

- The government will provide a Small Business Financing Program until the end of 1992 to help small businesses in difficulty, including farmers, to obtain loans at lower interest rates.
- The ceiling for loans to individual small businesses under the *Small Business Loans Act* will be doubled to $200,000.

Venture capital

- The government will encourage the growth of labour-sponsored venture capital funds. The maximum credit for investment in these funds will be increased to $1,000 from $700.

Ethanol and methanol fuels

- Effective April 1, 1992, the excise tax on the ethanol and methanol portions of blended fuels that are mainly gasoline will be eliminated.

Lifetime capital gains exemption

- The $100,000 lifetime capital gains exemption will be targeted toward more productive investments. The exemption will no longer be provided to capital gains accrued on real estate after February 1992.

Action to meet social responsibilities

Enriching benefits for families with children

- The current system of child benefits will be reformed and enriched. One monthly child tax benefit will replace the current patchwork of assistance, which includes family allowance, child credits and a refundable child tax credit. Unlike the family allowance, it will not be subject to tax. All children under the age of 18 will be eligible. The new benefit will include a new earned-income supplement of up to $500 per year for low-income working families with children.
- The benefit will be as much as $144 per month for one child, for a total of $1,733 per year. Benefits will be phased out for higher-income families on the basis of family net income rather than individual income.
- The new system will increase child benefits by $400 million per year. It will target them more fairly to low- and middle-income families.
- The maximum child care expense deduction will be increased by $1,000 to $5,000 for each child under seven and to $3,000 for other eligible children.

Promoting fairness

- Beginning in the 1993 tax year, the government proposes that common-law couples be treated the same as married couples under the tax system.

Canadians with disabilities

- The definition of expenses eligible for the medical expenses tax credit for the disabled will be expanded, and the range of tax-deductible business expenses for modifications to buildings and devices to assist the disabled will be broadened.
- The education credit will be made available to disabled individuals who attend a post-secondary educational institution on a part-time basis.
- Disability pensions under the Canada Pension Plan and Quebec Pension Plan will be recognized as earned income for purposes of contributions to registered retirement savings plans.

Increasing the education credit

- The amount on which the education credit is calculated will be increased from $60 to $80 per month of full-time study for the 1992 and subsequent taxation years.
- The limit on the total amount of tuition fee and education credits which may be transferred to another taxpayer will be raised from $600 to $680.

Retirement planning and savings

- The government will provide greater flexibility in retirement planning by extending the payout period for registered retirement income funds for life.
- The government will delay by one year the phase-in of higher contribution limits for registered pension plans and registered retirement savings plans.

Action to restrain expenditures

- **The government will cut spending by $1 billion in 1992-93 and by $7 billion over five years.**
- The Expenditure Control Plan, which was introduced in the 1990 budget and extended by last year's budget, will be broadened and deepened. Major transfers to provinces are not affected.
  - Defence spending will be cut by a total of $2.2 billion over the next five years, a substantial peace dividend for Canada.
  - The government will cut the non-wage operating budgets of departments by 3 per cent to save $150 million next year and thereafter.
  - First-class travel for MPs, Senators and senior public servants will be eliminated. International travel will be reduced.
  - The government will save $75 million a year by reducing communications budgets. A no-frills publishing policy will substantially reduce the number and cost of government publications.
  - The growth in spending by Canada Mortgage and Housing Corporation on social housing will be held to an average of 3 per cent per year.
  - Other programs will be reduced to save $170 million next year.
- **The Prime Minister and all Ministers will take a 5-per-cent cut in their ministerial salary beginning April 1.**

Streamlining government and improving service

- The government will restructure and streamline the operations of government to improve both efficiency and service to Canadians.

Reducing the number of government agencies

- Forty-six government entities will be eliminated, deferred, merged with other operations or privatized. The government will continue to privatize Crown corporations and dispose of surplus assets.

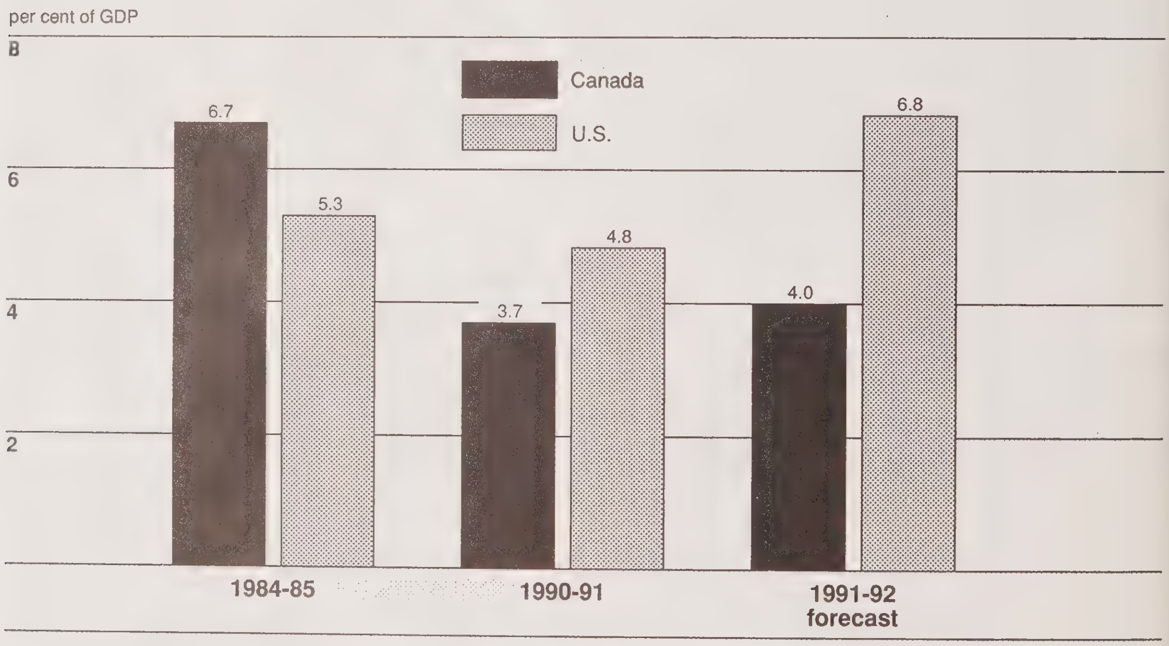
Improving service to Canadians

- Federal departments and agencies offering related services to individuals and businesses will take all reasonable steps to bring their services together in one place.
- Procedures for dealing with the federal government will be simplified, and standards of service will be developed for such things as longer hours of opening and faster responses.
- Government regulations will be reviewed department-by-department. Existing regulations that should be kept will have to be publicly rejustified.

Deficit reduction

- The deficit is forecast to decline to $27.5 billion in 1992-93, and fall steadily thereafter.

Comparable Canada - U.S. federal government deficits



Note: Financial requirements for Canada and Unified Budget Basis (UBB) balance for the United States.

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Tax support for small business

Canada's federal tax system provides considerable support for small businesses. Tax measures such as a lower tax rate for small business, special treatment for capital gains and enhanced incentives for research and development reduce federal taxes paid by small businesses by more than $3 billion annually.

This information sheet highlights several tax measures which benefit Canadian small businesses and compares them with the tax treatment of small business in the United States. While it does not cover all aspects of the Canadian and U.S. tax systems, it identifies areas of particular importance for small businesses in Canada.

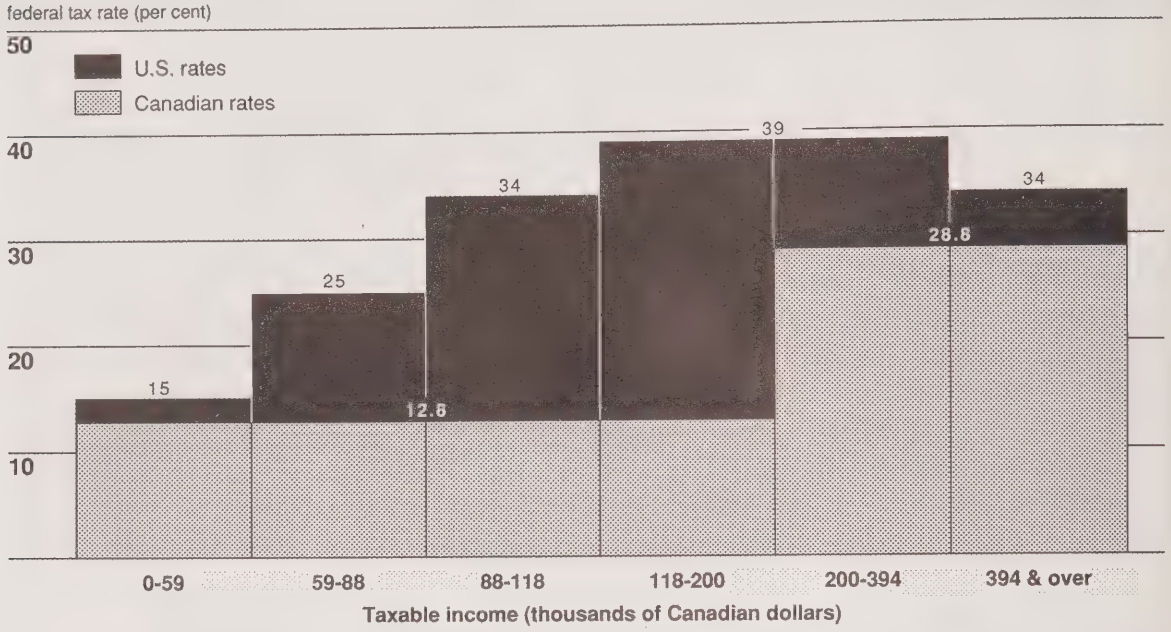
Lower tax rates

Federal corporate tax rates for small business are much lower in Canada than in the U.S. The key difference: Canadian-controlled private corporations are eligible for a special deduction that reduces their federal income tax rate from 28.8 to 12.8 per cent (including the 3-per-cent surtax) on the first $200,000 of business income.

By contrast, the preferential small business tax rate treatment in the U.S. applies only up to income of U.S. $75,000 (Cdn. $88,000). Income above this level is subject to the full 34-per-cent tax rate. An additional 5-per-cent tax also applies for income between U.S. $100,000 and U.S. $335,000. The chart on the next page illustrates the advantages to small business corporations in Canada. Provincial and state tax rates are also important. Many provinces also provide special reduced tax rates to small business. This is in addition to small business "tax holidays" and tax incentives for venture capital corporations investing in small business.

The average provincial small business income tax rate is about 8 per cent, which is higher than the average effective U.S. state corporate income tax rate of about 5 per cent. Yet since federal rates are much lower in Canada, the combined federal and provincial small business tax rate is below the combined federal and state corporate tax rate in the U.S. at most income levels.

Comparison of federal small business corporate tax rates, 1991



Notes 1: Exchange rate: U.S. $1 = Cdn. $0.85

2: Provincial and state taxes also apply. The average provincial corporate tax rate on small business is about 8 per cent. The average state corporate tax rate is about 5 per cent.

Lifetime capital gains exemption

Canada's lifetime capital gains exemption provides an incentive for individuals to invest in small business. Sales of qualified small business shares are eligible for an exemption of $500,000. This is particularly advantageous for a husband and wife because spouses may file separate tax returns when reporting income from their business. This means that a full $1 million in capital gains may be earned tax free.

In addition, only 75 per cent of capital gains above the exemption is subject to tax in Canada.

The U.S. tax system does not provide an exemption for capital gains, or a comparable preferential tax rate. The entire capital gain is subject to tax in the United States.

Research and development

The Canadian system has generous tax incentives for scientific research and experimental development (R&D). In a recent study, the Conference Board of Canada showed that Canada's system of R&D tax incentives is the most generous of all G-7 countries. Both current and qualified capital R&D expenditures are deductible in full as they are incurred, and are eligible for tax credits.

The general R&D tax credit rate is 20 per cent. Small businesses receive an even higher level of incentive. Eligible Canadian-controlled private corporations may earn tax credits at 35 per cent, and the credits are refundable up to certain limits.

The U.S. system of R&D tax incentives is not as generous. It does not allow capital

expenditures to be written off fully in the first year. A 20-per-cent R&D tax credit is available, but it can only be earned on "incremental" qualifying current R&D expenditures – that is, on those expenditures in excess of a base period amount.

The dividend tax credit

In the United States, business income distributed as dividends is effectively taxed twice – companies are taxed on this income at the corporate rate, and then shareholders are taxed at their personal rate when they receive dividends.

The Canadian tax system alleviates this double taxation by providing shareholders with a dividend tax credit. This credit means that dividend income is taxed at a much lower rate. Including provincial and state taxes, the combined personal and corporate tax rate in Canada on income qualifying for the small business deduction is just over 45 per cent, compared to about 60 per cent in the U.S.

In some cases, shareholders of certain closely held corporations carrying on a business in the U.S. may treat corporate income as personal income, and pay personal tax on the income as it is earned in the business. However, this provision is much narrower and less beneficial than Canada's approach to taxing small business corporations.

Lower health costs

For small businesses, health care costs in Canada are much lower than in the U.S.

In Canada, health care costs are covered by universal public medicare, which is funded out of general tax revenues and employer contributions. In 1989, the average contribution by Canadian employers was about $350 for each employee.

In the U.S., private health care costs for businesses are much higher – especially for small businesses that are unable to qualify for the discount premiums available to some of the larger firms that insure many employees. According to a study by the National Federation of Independent Business, the average annual health care costs for small business employers in the U.S. amount to over $3,500 for each employee.

Lower social security and payroll taxes

Social security and payroll taxes are of particular concern to small business in both countries. These taxes must be paid on behalf of each employee regardless of the level of profits being generated by the business.

Total social security and payroll taxes in Canada are significantly less than in the United States. In 1989, these taxes amounted to 4.6 per cent of GDP in Canada, compared to 8.8 per cent of GDP in the U.S. In fact, Canada's level of social security and payroll taxes as a percentage of GDP is the lowest of all G-7 countries.

Recent budget measures

Canada's 1992 federal budget contains two additional measures that will directly enhance the competitiveness of the country's system of small business taxation. Both of these measures will help to answer small business financing needs.

The Small Business Financing (SBF) program will allow incorporated and unincorporated small businesses in financial difficulty to borrow funds and refinance at interest rates below those normally charged in the market. The program operates by providing preferential tax treatment to interest received on SBF loans, permitting financial institutions to reduce the amount of interest charged to small business borrowers.

The second measure improves the access of small businesses to financial capital by increasing the maximum amount that can be loaned to them under the *Small Business Loans Act* (SBLA). The allowance for increased government-guaranteed SBLA loáns will better equip small businesses to finance start-up capital, and capital for expansion and modernization of existing enterprises.

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Tax changes for manufacturing and processing

Manufacturing and processing accounts for almost one-fifth of Canada's economic output and employment. This key economic sector competes in increasingly open international markets. This provides an opportunity for Canadian firms to grow, but it also means that these firms face intense competition for investment and market share. Over 40 per cent of Canada's manufactured output is exported, and the rest is sold domestically in competition with foreign imports.

The manufacturing and processing sectors in all major nations are restructuring. This process is not complete in Canada. More has to be done by all stakeholders in our economy to ensure that we remain competitive in world markets.

The budget proposals

The 1992 budget proposed several tax changes to enhance the competitiveness of Canadian manufacturing. These changes – worth some $2.7 billion over five years – will help companies in this sector improve productivity and take advantage of new opportunities in today's global markets.

Increased capital cost allowance

The budget proposes to increase the capital cost allowance (CCA) rate for eligible manufacturing and processing machinery and equipment from 25 to 30 per cent.

CCA deductions are an important component of the income tax system. They provide businesses with deductions in computing taxable income to reflect the cost of depreciable assets.

A higher CCA rate reduces after-tax costs in the early years of an investment and increases the financial return on the investments. Therefore, it can be an important consideration in decisions to modernize plants and equipment in order to improve productivity.

Under the proposed CCA rates, businesses could write off almost 60 per cent of the cost of the assets in the first three years of use.

Lower tax rate on manufacturing and processing profits

The budget also proposed a reduction in the tax rate on profits from manufacturing and processing activity. The reduction – from 23 to 21 per cent – will be implemented in two steps: a one percentage point drop in the tax rate on January 1, 1993, and a further one-point reduction on January 1, 1994.

By increasing the long-term financial return to investors, this reduction in the tax rate is expected to encourage firms with existing facilities in Canada and abroad to locate production – and the employment associated with it – in this country.

When combined with the changes in the CCA rate, this new tax rate will lower the marginal effective tax rate on an investment in machinery and equipment in Canada for large manufacturing companies by about 2.8 percentage points. As a result, the marginal rate in Canada will be about one percentage point lower than in the U.S. The marginal effective rate is used to analyze the effects of the tax system on new investments.

Marginal effective tax rate on investment in machinery and equipment

	Current	Proposed
Canada	23.4	20.6
U.S.	21.6	21.6

Withholding tax reduction on direct dividends

The budget announced that the government is prepared to reduce the withholding tax on dividends paid directly to foreign residents. This action makes Canada more attractive to foreign investors.

The rate will be reduced to 5 per cent over a five-year period beginning as early as January 1, 1993. The reductions will be implemented through bilateral treaty negotiations with our major trading partners.

The rate of withholding tax on dividends has an effect similar to that of the statutory tax rate on the investment and operation decisions of foreign-owned firms. Withholding taxes imposed on after-tax earnings distributed by a subsidiary can represent an additional tax burden over the corporate income tax paid. In today's international business environment, a high rate of withholding tax can act as an impediment to international investment in Canada. During a period of worldwide industrial restructuring, Canada must not act in ways that hinder our ability to attract new investment. As well, because withholding taxes are negotiated on a reciprocal basis, high withholding taxes can also hinder the investment plans of Canadian-based multinational companies.

When the reductions of the tax rate and the withholding tax rate are fully implemented, the effective federal-provincial statutory tax rate on manufacturing and processing income earned in Canada will fall to 35 per cent for a Canadian company and to 38 per cent for a Canadian subsidiary of an American company. These rates are lower than the statutory rate in the U.S., which is 39 per cent.

Support for research and development

Manufacturing companies are major performers of research and development. They benefit from a system of R&D tax credits that is one of the most generous in the world. The 1992 budget proposes to enrich these tax credits and streamline their administration to make them more efficient.

Two key areas for examination are:

- treatment of capital equipment used for both research and production purposes; and
- allocation of certain overhead and administration costs between research and development and other activities.

Effective statutory tax rates on M&P income earned in Canada and the United States

	Income earned in Canadian subsidiary		Income earned by
	Current	Proposed	U.S. parent
		(per cent)	
Federal[1]	24	22	34
Provincial/state[2]	13	13	5
Total income tax	37	35	39
Net withholding tax[3]	6	3	n/a
Total income and withholding tax	43	38	39

[1] Basic M&P tax rate plus the 3-per-cent surtax.

[2] Provincial and state tax rates are averages. Actual rates will vary across jurisdictions. The state tax rate reflects the fact that state taxes are deductible for federal tax purposes in the United States.

[3] The withholding tax applies to dividends paid to the foreign parent out of after-tax income of the subsidiary.

Finance Information

92-04 The Department of Finance May 1992

Canadian tax facts

Taxes play an important role in determining the well-being of Canadians by funding important social programs, including education, senior citizen and family benefits, health care and municipal services. The type and level of taxation also has an important effect on the nation's international competitiveness as it influences decisions affecting investment, economic growth and sustainable job creation.

Since 1984, the government has reformed the tax system to improve tax fairness and eliminate major economic distortions. As a result, the tax system now helps to ensure that Canada remains competitive in today's global marketplace, so we can continue to enjoy a high standard of public programs and services.

The 1992 budget: lower taxes

The 1992 federal budget announced a series of measures to provide tax relief to Canadians. These measures will reduce personal income taxes by $7.5 billion over the next five years.

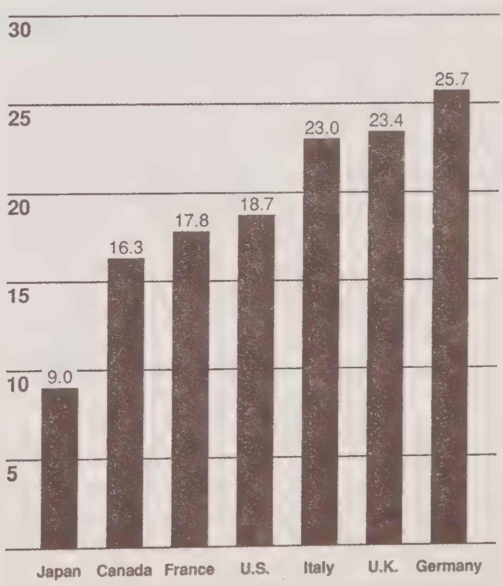
- All 14.6 million taxpayers will have their tax burden reduced through a staged 2-per-cent reduction in the general surtax. This will lower the general surtax rate to 3 per cent of basic federal tax by January 1, 1993.
- The new enriched Child Tax Benefit will reduce taxes for low- and middle-income families.
- Tax relief will be increased for Canadians with disabilities, child care expenses or education costs.

Low rates of personal taxation

Canada is sometimes identified as having the highest level of personal taxation among the leading industrial nations. However, this compares personal income tax only, ignoring the fact that other G-7 nations levy much higher social security taxes, which are also paid by individuals.

According to an OECD study, the average Canadian production worker with a family paid less in income tax – federal, provincial and local – and social security contributions in 1990 than the workers in 18 other nations, including the U.S. and every other G-7 nation except Japan.

Taxation of average production worker[1]
Single-income couple with two children



[1] Income tax and employee's social security contributions as a percentage of 1990 gross earnings.

Budgetary revenues close to levels of the early 1970s

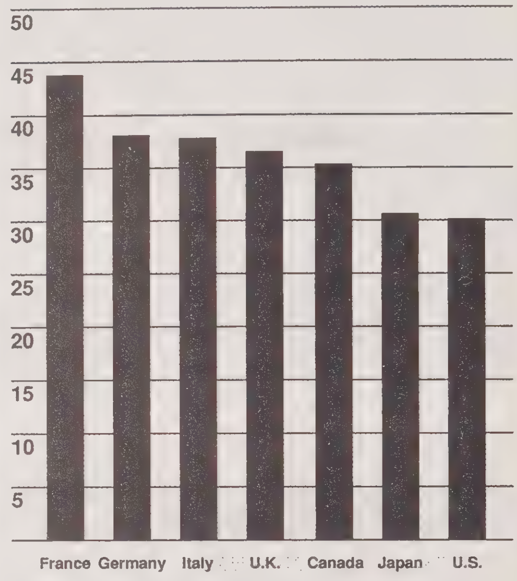
For 1991-92, federal budgetary revenues equalled 18.2 per cent of our total economic output, or gross domestic product (GDP). While this represents an increase over 1984-85, it is comparable to the level of taxation experienced between 1969-70 and 1973-74, when budgetary revenues averaged 17.3 per cent of GDP.

Increased tax revenues have helped cut the federal deficit almost in half from its peak of 8.7 per cent of GDP in 1984-85. However, most of this improvement in Canada's fiscal situation has been due to spending restraint.

Taxation lower than in other nations

Canada's total tax revenues – federal, provincial and local – were equal to roughly one-third of our GDP in 1989. Among the G-7 nations, this is a lower proportion than in France, Germany, Italy and the United Kingdom.

Total tax revenue of G-7 nations
Percentage of gross domestic product – 1989



Source: OECD (1991), *Revenue Statistics of OECD Member Countries, 1965-90*

Corporations now paying more tax

Tax reforms since 1984 have eliminated most loopholes and tax incentives that resulted in large numbers of profitable corporations not paying any corporate income tax. In addition, the Large Corporations Tax introduced in 1989 ensures that all large Canadian corporations pay tax each year. This tax raises about $1 billion annually.

As a result of these reforms, federal corporate income tax revenues in 1991-92 were about 15 per cent higher than in 1983-84, despite the fact that corporate profits in 1991 were about 40 per cent lower than in 1984.

Corporate tax reform also recognizes the role business plays in generating economic growth and new jobs. The 1992 federal budget announced a number of initiatives to strengthen the competitiveness of Canadian business, including the manufacturing and processing sectors which account for almost one-fifth of all jobs.

A better sales tax system

The introduction of the GST to replace the hidden Manufacturers' Sales Tax (MST) represents a significant improvement in Canada's tax system. By eliminating sales tax on business inputs, the GST will stimulate investment and strengthen the ability of Canadian firms and workers to compete at home and abroad.

As part of the GST reform, a tax credit is paid to low- and modest-income Canadians. The credit – up to $190 for each adult and up to $100 per child – is designed to ensure that lower-income Canadians will pay less sales tax than they did with the MST, improving the fairness of our national tax system. Calculations by the Department of Finance, using expenditure patterns identified by Statistics Canada, show that a one-income family of four – with two children and earnings of $25,000 – would save about $225 under the GST, as compared with the old MST regime.

The GST is a more stable and secure source of revenue and will ensure that the federal government can make further progress in reducing the deficit. Legislation has been introduced to ensure that all net GST revenues will go directly to the Debt Servicing and Reduction Account.

Finance Information

92-05 The Department of Finance May 1992

Tackling the fiscal problem

In 1984, one of the most serious problems the government faced was the high federal deficit and soaring public debt.

The problem

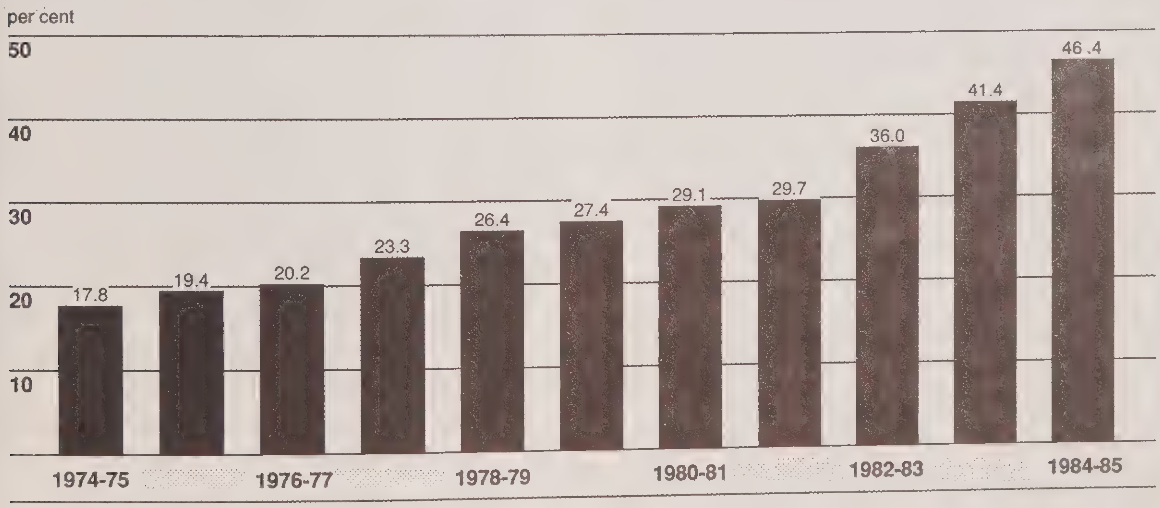
In the late 1970s and early 1980s, the federal government stopped paying its way. It spent more than it received in revenues. The result was that the operating balance, the balance before interest payments, went into deficit after 11 years of surplus. By 1984-85, the operating deficit was $16 billion and the federal government spent $1.33 on programs alone for every dollar of tax revenues.

High operating deficits combined with high interest rates sent deficits and debt soaring. By 1984-85, the federal deficit had reached 8.7 per cent of GDP – a postwar record. Net public debt was rising at a rate in excess of 20 per cent a year and had reached 46.4 per cent of GDP – 2 1/2 times the share in 1974-75. Twenty-five years of progress in reducing the burden of the public debt had been thrown away in only one decade.

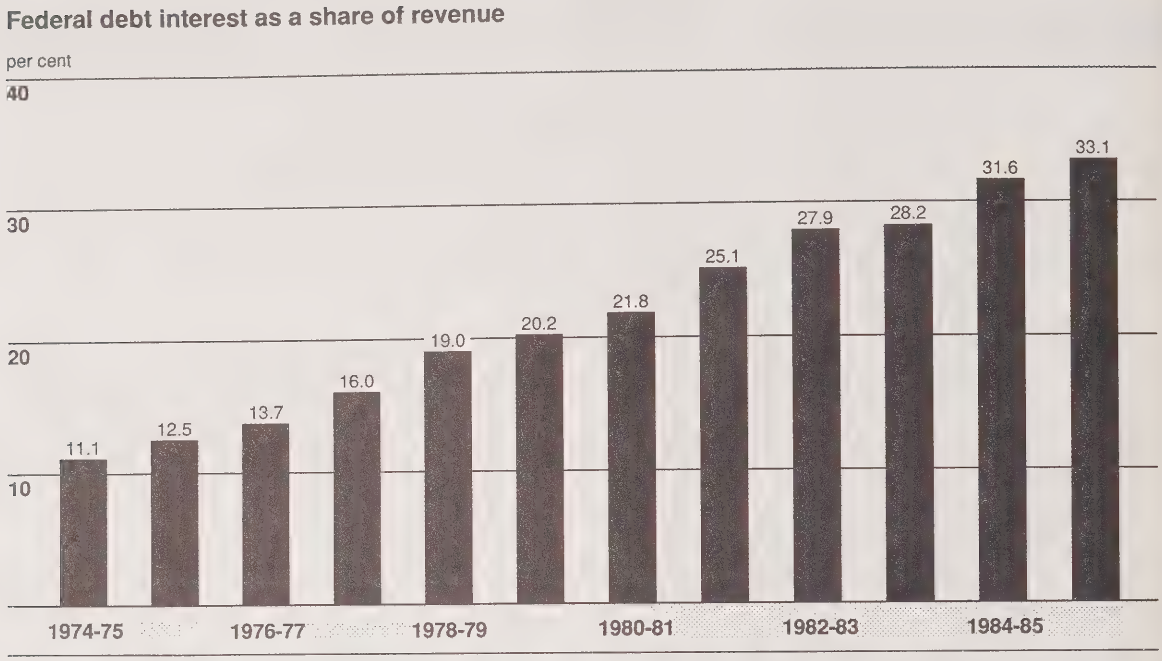
The fiscal situation was unstable. The spiralling debt meant that more and more spending was simply to pay interest on the burgeoning debt. By 1985-86, one in every three dollars of federal revenue went to pay interest – triple the share in 1974-75.

Growth in government spending had to be reduced and new revenues raised just to pay the interest on each year's new debt. As well, the nation's finances were becoming

Net federal debt as a proportion of GDP



Source: Department of Finance.



increasingly vulnerable to fluctuations in world interest rates.

The policy

Since then, the federal government has acted strongly to lower the deficit and control the growth in debt. The deficit has been halved relative to GDP and growth of the debt cut by 60 per cent. Most of the progress reflects program spending restraint.

The alternatives

What were the alternatives to the approach taken by the government to the deficit/debt problem?

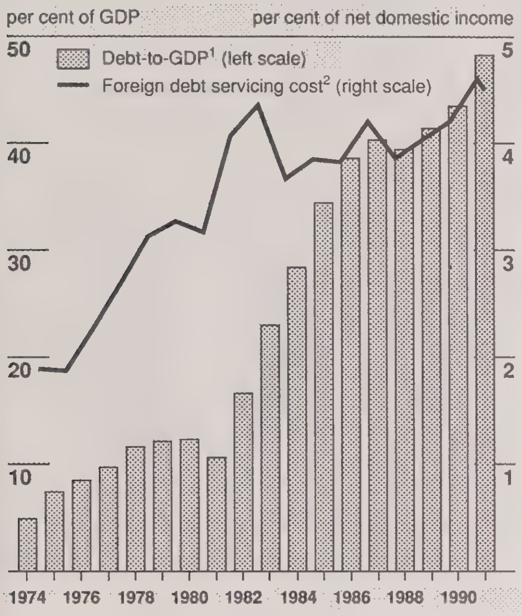
The serious fiscal situation could have been simply ignored, or a "go slow" approach adopted with regard to rectifying it. The magnitude of the problem, however, and the fact that it was worsening, made this an unacceptable choice.

For example, in 1984-85, program expenditures were 19.6 per cent of GDP, while revenues were only 16.0 per cent. If revenues and expenditures had been left at those shares of Canada's output, the deficit would have soared to $82.2 billion in 1990-91, instead of the actual $30.6 billion. Net public debt would have risen to 84 per cent of GDP and interest costs would have consumed 54 cents of every dollar of revenue.

Letting the debt continue to balloon would also have had severe negative consequences for the economy:

- The spiralling deficits and debt would have reduced confidence in Canada for both foreign investors and Canadians. Interest rates would have risen as investors demanded a greater return to compensate them for the risks of investing in Canada.
- At the same time, the Bank of Canada would have had to severely tighten monetary policy to control and reduce the inflationary pressures which would have resulted from huge fiscal deficits.
- These higher interest rates would have, in turn, only exacerbated the problem of rising debt servicing costs and high deficits.
- Higher interest rates and reduced investor confidence would have increased the cost of raising capital for firms, leading to reduced

Government debt as a proportion of GDP and foreign debt servicing cost as a proportion of net domestic income



[1] Total government debt on a national accounts basis.
[2] Difference between net domestic and national income.

investment, a lower stock of productive capital and a reduced output of goods and services resulting in fewer jobs and lower incomes for Canadians.

- The huge deficits would have greatly exceeded domestic savings and led to an excessive reliance on foreign sources of funds to finance fiscal deficits and domestic investment, greatly increasing our net foreign indebtedness. Even with the actions already taken, the cost of servicing our foreign debt has risen from under 2 per cent of our net national income in 1974 to 4.6 per cent by 1990, before declining to 4.5 per cent in 1991.

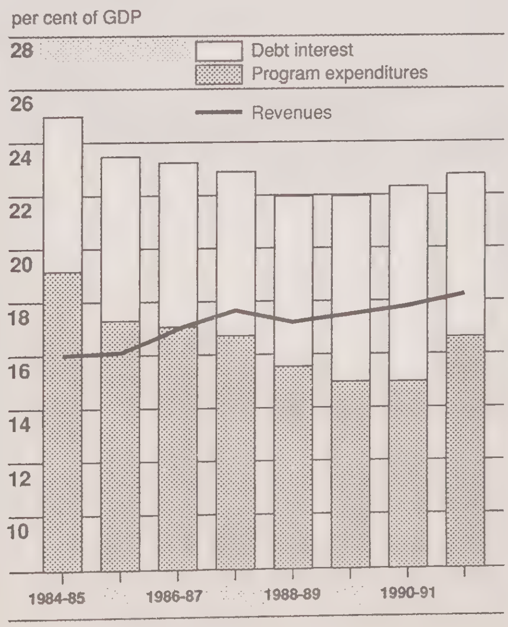
Another option was to sharply raise personal and corporate income taxes. These, however, were already high, and such a move would have been internationally uncompetitive given the reductions in tax rates which were occurring elsewhere during the 1980s in an effort to reduce the disincentive and distortionary effects which are associated with high marginal tax rates. Expenditures could have been cut more, but this would have had negative consequences for the social safety net.

A policy of lowering interest rates could have been adopted to lower debt servicing costs. Such a policy would have brought only temporary benefits and would have quickly worsened the situation. The experience in Canada in the late 1970s and early 1980s as well as around the world shows conclusively that trying to lower interest rates without getting inflation down only fuels inflationary pressures. Eventually higher inflation leads to even higher interest rates and deficits.

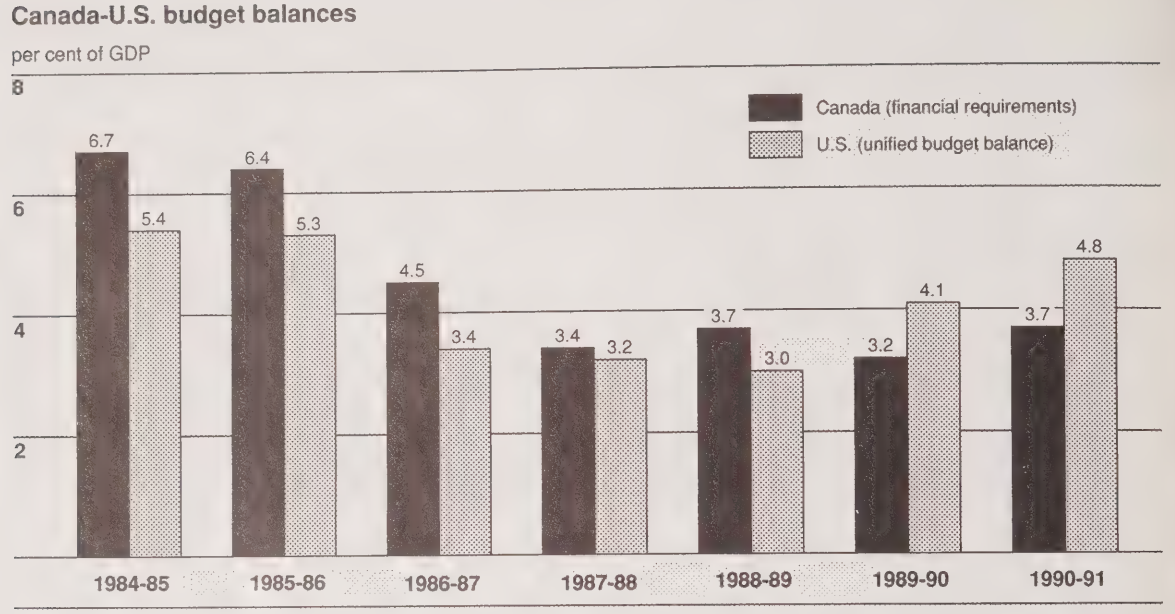
The result

Substantial progress has been made since 1984-85. Program spending has been reduced from 19.6 per cent of GDP in 1984-85 to 16.0 per cent in 1990-91 – the lowest level since 1970. The operating balance has moved from a deficit of $16.1 billion in 1984-85 to a projected surplus of $12.7 billion in 1992-93.

Federal revenue and expenditure shares of GDP



Source: Department of Finance.



Sources: Department of Finance and U.S. Office of Management and Budget.

The measures taken will stabilize the net federal debt as a proportion of GDP over the next two years.

The government has put in place a structure that will ensure continued progress over the medium term. The reform of the personal and corporate tax systems and the replacement of the Manufacturers' Sales Tax (MST) with the GST has made the tax base more reliable and stable. The Expenditure Control Plan, first introduced in the 1990 budget, was broadened and deepened in both the 1991 and 1992 budgets. The unemployment insurance system has been put on a financially sound basis. These measures, along with other steps taken by the government, will ensure that program spending remains under control and that the deficit will decline substantially over the medium term.

In the last eight years, Canada has achieved significantly greater reductions in the federal deficit as a proportion of GDP than has the United States. Since 1987-88, the Canadian federal government has had an operating surplus, that is, revenues have exceeded program expenditures.

In the U.S. however, program expenditures are expected to stay above revenues until 1995. The federal government portion of the general government-sector deficit is lower in Canada than in the U.S. However, the overall U.S. deficit position is lower because the American states run a surplus while Canada's total provincial, local government and health sector is in deficit. The reduction in Canada's general government deficit as a proportion of GDP was at the G-7 average between 1984 and 1989, while the reduction in Canada's deficit as a proportion of GDP was greater than the general government average for G-7 countries during those years.

The fiscal structure is now in place for a sustainable reduction in the burden of federal government indebtedness. The key elements of this structure are:

- enhanced revenues;
- restraint in expenditures; and
- a resulting reduction in the burden placed on monetary policy, which combined with lower inflation is enabling interest rates to decline to sustainable lower levels.

Finance Information

92-06 The Department of Finance May 1992

The benefits of reduced inflation

One of the key elements of the federal government's economic action plan has been to reduce and control inflation to achieve sustainably lower interest rates.

The problem

Following the 1981-82 recession, the Canadian economy enjoyed a lengthy expansion. Eventually, however, demand began to outstrip the economy's capacity to supply goods and services on a sustained basis. As a result, inflationary pressures mounted sharply beginning in the late 1980s.

Canada's inflation problem could not be ignored. Left unchecked, high and rising inflation would have damaged the economy in a number of serious ways.

- High inflation results in high interest rates, as lenders demand a higher rate of return to compensate for their loss in purchasing power. During the 1970s and up to the early 1980s, inflation rose steadily from 2.9 per cent to a peak of 12.4 per cent and long-term bond rates rose from 7 per cent to over 15 per cent.
- The risk premium on the real cost of funds for business investment rises with inflation, as the added uncertainty associated with high inflation makes investment risky. For example, as inflation rose from the early 1970s to the early 1980s, the real cost of funds trended upwards, reaching a peak of 10.4 per cent by the second quarter of 1982. As inflation came down, so did the cost of funds. In 1991, it averaged 6.5 per cent.
- Countries that enjoy low inflation also enjoy a low risk premium and a low cost of capital and interest rates. Germany and Japan during the 1980s are two important examples.
- High interest rates and a high cost of capital, by depressing investment spending, lower the economy's potential to grow.

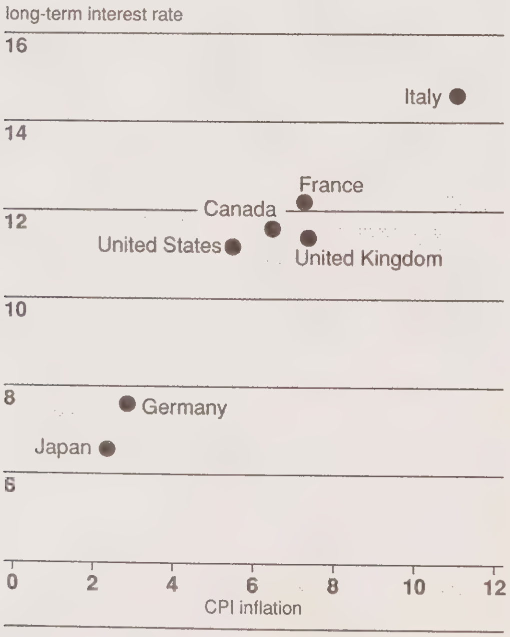
Inflation has had a negative impact on Canada's competitive position.

- Although Canadian inflation was much lower in the second half of the 1980s than in the first half, it was nonetheless higher than that of our principal trading partners. This poor price performance contributed to the high growth in domestic unit labour costs that reduced our competitive position in the late 1980s. In domestic currency terms, Canadian manufacturing unit labour costs rose by 25 per cent from 1985 to 1990, while those in the United States increased by only 4 per cent over this period.

- The erosion of Canada's competitive position resulting from high inflation was partly offset by the depreciation of the Canadian dollar in the late 1970s and early 1980s. However, the dollar's fall during that period merely added to inflationary pressures at home and did not solve the economy's fundamental problem with high inflation.

Finally, inflation has undesirable income redistribution effects. Those less able to protect themselves from the effects of inflation – typically the working poor and those on fixed incomes – are hit hardest by inflation. For example, the consumer price index rose by 2 1/3 times from 1971 to 1981, the year when inflation peaked. In that decade, individuals on fixed incomes would have seen their real incomes fall by 60 per cent. In contrast, those in a better position to take advantage of sophisticated financial advice could profit from the high inflation of the period.

Inflation and long-term interest rates in G-7 economies 1980-89 average



The policy

To control and reduce the strong inflation pressures of the late 1980s, monetary and fiscal policy were oriented to restraint. The federal government and the Bank of Canada are committed to achieving price stability over time.

- Monetary policy remained firm in the face of rising inflation pressures and monetary conditions tightened. Federal government expenditures (including wage expenditures) were constrained and revenues increased.
- In the February 1991 federal budget, the government and the Bank of Canada announced that they were establishing intermediate inflation targets as key steps toward achieving price stability. These inflation targets – measured by year-over-year increases in the consumer price index (CPI) – have been set at 3 per cent by the end of 1992, 2.5 per cent by the middle of 1994, and 2 per cent by the end of 1995.

The alternatives

What were the alternatives to a policy of price stability with explicit targets along the way? One alternative was to accept a higher rate of inflation. The argument is based on the assumption that inflationary pressures in the late 1980s were not overly strong, and that inflation would not get out of hand.

- Without the firm response to mounting inflationary pressures, inflation might have risen dramatically. In fact, not resisting the upward pressure on inflation risked repeating the damaging experience of the 1970s and early 1980s when inflation was allowed to get out of control and eventually reached 12.4 per cent.

Another alternative was not to let the dollar appreciate as much as it did.

- The tightening of monetary conditions and the consequent appreciation of the Canadian dollar helped to prevent a surge

in the rate of inflation. We estimate that the increase in the dollar from its early 1986 level lowered the rate of inflation by an annual average of nearly one percentage point from 1986 onwards.

Still another alternative to the present policy was to try to maintain a constant rate of inflation of 4 to 5 per cent in the late 1980s, rather than attempting to reduce inflation.

- Even if an inflation rate of 4 to 5 per cent could be sustained, this rate would still have been higher than that in our major trading partners, thus damaging our competitive position.
- Even relatively low rates of inflation cause economic hardships. For example, an inflation rate of 5-per-cent cuts the purchasing power of a person on a fixed income by one-half in 14 years.

Some observers argue that pursuing a policy of price stability when indirect taxes constitute a large share of measured CPI inflation is an unrealistically onerous task.

- Increases in indirect taxes are a part of the policy of reducing fiscal deficits and as such they reduce demand and inflation pressures. These increased tax rates have not had an ongoing impact on inflation.
- Although indirect tax increases did increase the price level by just under 1 1/2 per cent in this period, it was the increases in underlying cost pressures, most notably unit labour costs, that were the key concern in terms of ongoing pressures on costs and on Canada's competitive position.

The result

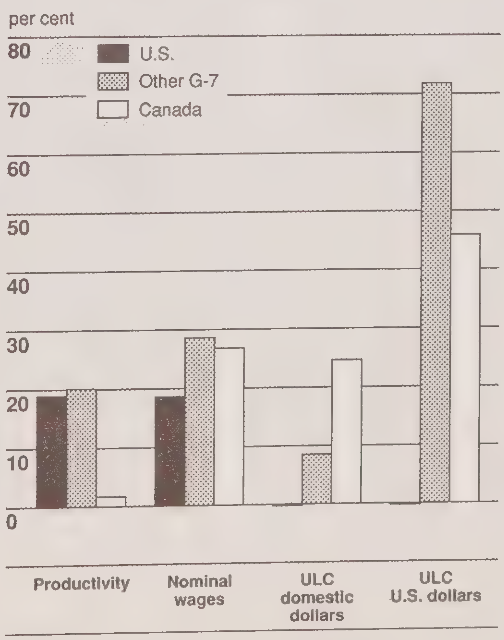
The combined efforts of monetary and fiscal policy to lower inflation have been effective.

- Canada's year-over-year inflation rate fell throughout 1991. This drop was masked in the year-over-year inflation rate, which included the one-time jump in price levels associated with the introduction of the GST in January 1991. The slackening in inflation was very evident, however, in month-to-month increases in the CPI.
- As the one-time effect of GST introduction ceased to be a factor in the year-to-year figures as of January 1992, the inflation rate fell sharply to 1.6 per cent from 3.8 per cent in December.

This policy is already paying dividends in terms of lower interest rates:

- Short-term interest rates have plunged from a peak of 14.03 per cent in Spring 1990 to 7.7 per cent by mid-March, a drop of roughly 630 basis points.
- Since May 1990, one-year mortgage rates have fallen from 14.25 per cent to 9.5 per cent. This represents a saving of $243 per month on a $75,000 mortgage amortized over 25 years.

Cumulative increase in manufacturing unit labour costs 1985 to 1990



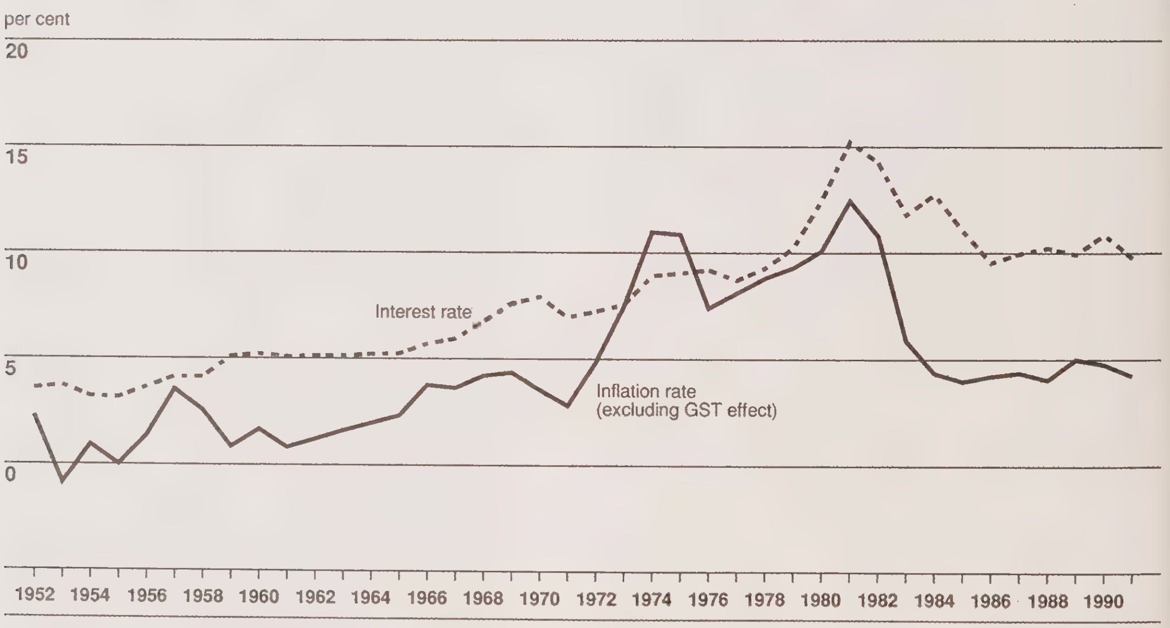
Source: United States Bureau of Labor Statistics.

- The cost of debt has also fallen for small businesses which typically pay prime plus 2 percentage points. The drop in prime rates has resulted in a saving of $744 per month on a $200,000 loan amortized over 10 years.
- Wage settlements also show that inflationary pressures are coming down. Average settlements in the public sector (2.4 per cent) and in the private sector (3.3 per cent) in the fourth quarter of 1991 were well below the averages for the fourth quarter of 1990 (5.5 and 5.2 per cent respectively).
- In the long run, there is not a choice between higher inflation and unemployment and output growth. As the experience of the 1970s and early 1980s shows, when inflation is allowed to rise **both** employment and output growth weaken. When Canada kept inflation low and stable – from 1950 to the mid-1970s – output and employment growth were strong.

Nevertheless, the tight monetary policy aimed at lowering inflation has had impacts on output.

- This cost does not mean that the policy course should not have been followed. In fact, it shows how important it is to rid the economy of inflationary pressures and expectations, once and for all. The best path to recovery lies in the recognition by Canadian business, labour, and governments that inflation is on the road to being eliminated. The adjustment to price stability will be easier once all economic partners adjust their expectations accordingly.

Canadian inflation versus Canadian long-term government bond yield



Finance Information

92-07 The Department of Finance May 1992

The proposed Spending Control Act

As a vital part of the Plan for Economic Recovery, the 1991 budget provided for continued firm control of government program spending to reduce the deficit and the burden of debt.

To provide maximum assurance of spending restraint, the budget also announced the government's intention to impose mandatory limits on annual program spending.

A draft of the Spending Control Act was released last summer for public discussion and study by the House of Commons Standing Committee on Finance and the revised legislation was approved by the House of Commons and is currently before the Senate.

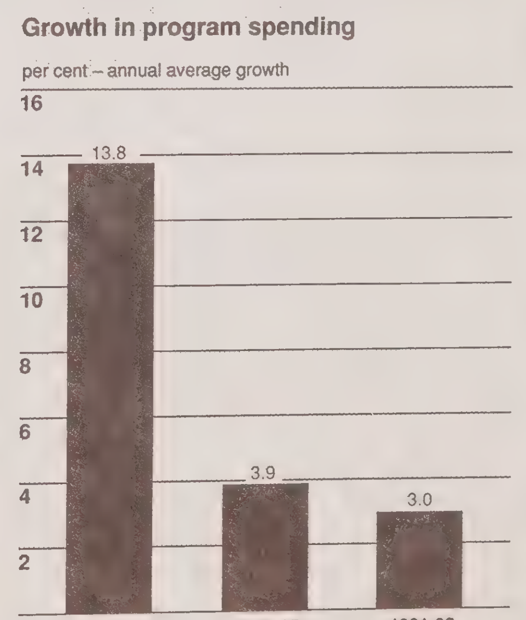
Spending restraint will be legislated

The proposed Spending Control Act puts a ceiling on government program spending – all spending except interest on the public debt – for a five-year period from 1991-92 to 1995-96.

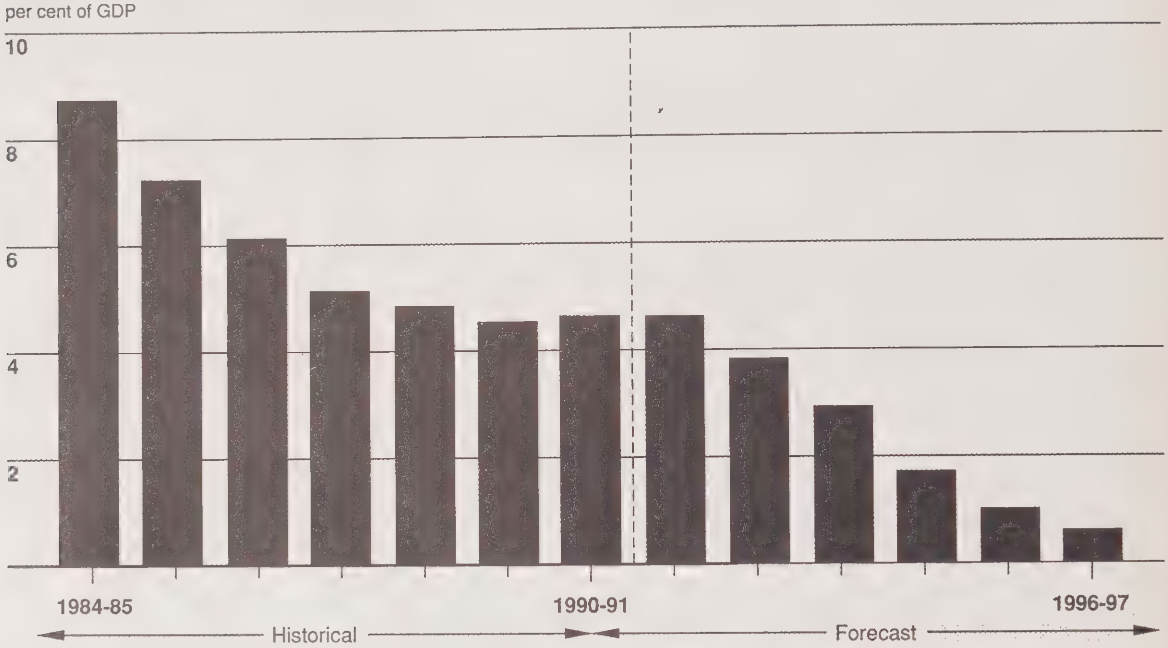
The allowable limits are the program spending projections contained in the fiscal plan presented in the February 1991 budget, excluding the spending for four self-financing programs. This exclusion covers all spending related to the Unemployment Insurance Program, and federal government advances to the Crop Re-insurance Fund, the Agricultural Commodities Stabilization Accounts, and the Gross Revenue Insurance Plan.

The Act would not allow either increased borrowing or tax increases to make up for any excess spending that might occur. Instead – with limited exceptions – overspending would have to be offset by program spending reductions.

The government must report on the Act in the Public Accounts of Canada, and the Auditor



The budgetary deficit
1984-85 to 1996-97



General has been asked to report on the government's compliance with the Act.

Ensuring accountability

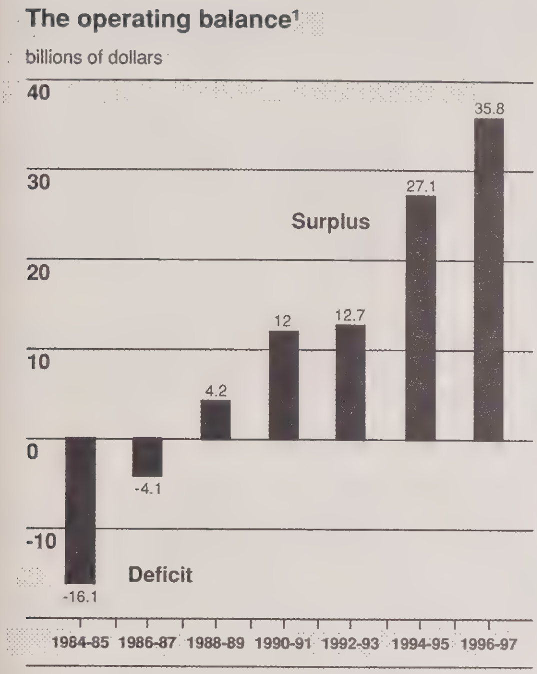
Program spending above the legislated limit in a particular year will have to be made up in the two following years, or at the discretion of the Minister of Finance, from cumulative under-spending in previous years, to ensure that the total spending limit from 1991-92 to 1995-96 is not exceeded.

If the limit is exceeded, the Minister of Finance must announce before or in the next budget how this excess would be recovered over the next two years.

A budget that is not consistent with the proposed Spending Control Act could not be presented without, at the same time, presenting legislation to amend the Act.

Dealing with contingencies

It is important to ensure that the controls are consistent with the efficiency or effectiveness of government operations and the ability to respond to contingencies. As a result, a limited number of exceptions are permitted under which the limits could be exceeded. They are: spending related to emergencies, disasters and external shocks; losses from the sale of assets; incremental funding for good management initiatives such as enhanced service and related cost-recovery to improve efficiency and reduce the deficit; and adjustments resulting from events occurring prior to 1991-92, such as revisions in data affecting past payments under a formula-funded program, or court decisions relating to programs in effect prior to 1991-92.



[1] Operating balance is the budgetary deficit excluding public debt charges, i.e. budgetary revenues less program spending.

Comparison with U.S. limits

Canada's proposed Spending Control Act provides for tighter control of spending than the United States' Budget Enforcement Act of 1990 – the successor to the "Gramm-Rudman-Hollings" Act. For instance:

- While the exemptions from spending limits are largely restricted to self-financing programs in Canada, in the U.S., all entitlement or statutory programs are exempted from changes due to economic reasons.
- For all other programs, the U.S. spending limits are adjusted on an ongoing basis for changes in inflation. No such adjustment would be allowed under Canada's Spending Control Act.
- The proposed Canadian law would prohibit increasing taxes to expand the spending limits, while the Budget Enforcement Act in the U.S. permits new spending initiatives to be financed through higher taxes as long as the deficit is not adversely affected.

Meeting the challenge of spending restraint

Living within the program spending limits of the proposed Spending Control Act will require difficult choices among competing spending pressures – spending more on some things will mean spending less on others. The government, however, has demonstrated its continuing commitment to expenditure restraint and the difficult choices it requires.

A real reduction in program spending

In the 15 years before 1984-85, program spending had been increasing at an average annual rate of 13.8 per cent. Since then, the growth in program spending has been reduced to 3.9 per cent – less than the rate of inflation, and therefore a reduction in real terms. Program spending as a share of annual economic output has been reduced from 19.6 per cent in 1984-85 to 16.7 per cent in 1991-92. It is projected to fall further to 13.9 per cent by 1996-97 – the lowest level in almost 30 years.

Major turnaround in the operating balance

Since 1984-85, the operating balance – program spending compared with revenues – has been turned around from a $16.1 billion deficit to a projected $12.7 billion surplus in 1992-93. The largest part of this progress has resulted from expenditure restraint.

Cost of government operations tightly restrained

Government operating costs – salaries, travel, accommodation and other overhead costs – have been tightly restrained, growing by an annual average of only 2.2 per cent since 1984-85.

As a proportion of total program expenditures, operating costs have declined from 16.8 per cent in 1984-85 to 15.0 per cent in 1991-92.

Reducing the deficit and the burden of debt

The deficit has been cut almost in half from its peak of 8.7 per cent of annual economic output in 1984-85.

The size of the debt in relation to the economy will begin to decline in 1993-94 and the government will begin to reduce its publicly held debt in 1995-96.

The Expenditure Control Plan

In the 1990 budget, the government introduced the Expenditure Control Plan, a comprehensive two-year approach to expenditure control and reduction.

This plan was extended in the 1991 budget, with tough new restraints on government salaries and all other operating costs. As well, the scope of the Plan was broadened and deepened in the February 1992 budget.

To further reinforce the Expenditure Control Plan and the legislated spending limits, the February 1991 budget introduced two other key measures. These were a set of inflation targets to systematically reduce both inflation and inflationary expectations, and the Debt Servicing and Reduction Account. All net GST revenues and net proceeds of the privatization of Crown corporations will go into this Account to pay the interest on the public debt, and over time, to pay down the debt itself.

Additional measures in the 1992 budget

The 1992 budget conforms fully with the terms of the Spending Control Act. Program spending subject to the Act totals $94.5 billion in 1991-92, and $99 billion in 1992-93, well under the limits for the two years, which are $97.2 billion and $100.9 billion respectively.

The budget also contained a number of measures to build on the Expenditure Control Plan. The new steps to further restrain spending and streamline government operations included:

- a 5-per-cent cut in the ministerial salaries of the Prime Minister and all Ministers;
- a 3-per-cent cut in the non-wage operating budgets of departments, to save $150 million in fiscal 1992-93, and $800 million over a five-year period;
- the elimination of first-class travel for MPs, Senators, and senior public servants;
- the saving of $75 million annually by reducing communications budgets;
- a cut of $2.2 billion over the next five years in defence spending, providing Canadians with a substantial peace dividend;
- a total of 46 government organizations to be eliminated, deferred, merged with other operations or privatized, and a more aggressive approach to the disposal of surplus assets and the privatization of Crown corporations.

To recovery and prosperity

Sustained spending restraint and deficit reduction will pay large dividends to Canada and the Canadian economy, helping to reduce inflationary pressures, and making possible lower interest rates. As a result, the cost of living and doing business has eased, helping Canada to compete more effectively in the tough global marketplace – and reap the benefits of sustained job growth and higher real incomes.

Finance Information

92-08 The Department of Finance May 1992

Debt Servicing and Reduction Account

The 1991 budget proposed a number of important measures to ensure that the deficit and the burden of the public debt will be reduced in the years ahead as a key part of the Plan for Economic Recovery. One of these measures is the proposed Debt Servicing and Reduction Account.

A Special-Purpose Fund to tackle the debt

The government has introduced legislation to establish the Debt Servicing and Reduction Account.

Revenues in the proposed Account will be used to pay the interest on the public debt and, over time, to pay down the net debt.

Into this Fund will flow:

- net revenues from the Goods and Services Tax;
- net proceeds from the sale of Crown corporations; and
- gifts to the Crown.

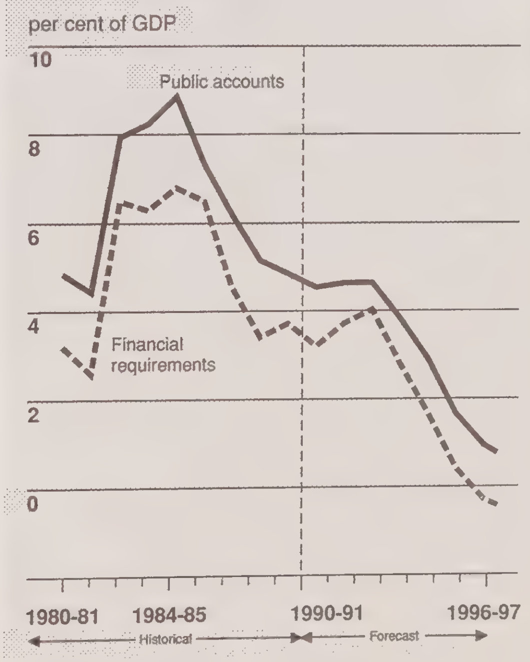
The Account will be audited annually by the Auditor General.

Greater assurance for deficit reduction

The establishment of the Account backs up the government's commitment to ensure that GST revenues will make a sustained contribution to deficit reduction.

The Account provides assurance that GST revenues will not be used to fund new spending – and will be used to reduce the deficit and, over time, the debt.

The deficit and financial requirements[1] 1980-81 to 1996-97



[1] Excluding foreign exchange transactions.

Reinforcing the initiative

To reinforce this initiative, the government also proposed in the budget to legislate limits on total program spending.

If spending were to exceed allowable limits for economic or policy reasons, reductions would have to be found. And borrowing or increases in taxes – including the GST – would not be allowed to fund excess spending.

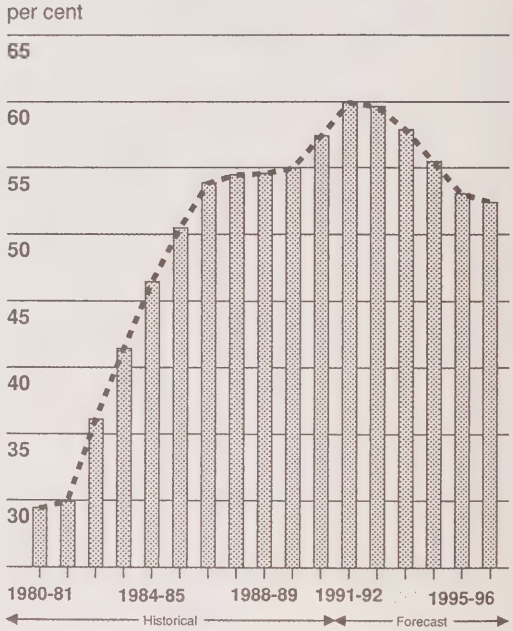
Once approved by Parliament, the proposed Debt Servicing and Reduction Account and the proposed Spending Control Act will be effective for the 1991-92 fiscal year which began April 1, 1991.

Sustaining fiscal progress

These measures will play vital roles in sustaining progress in restraining program spending, reducing the deficit and controlling the debt.

- Federal program spending growth has been held below inflation since 1984. Total program spending has dropped from 19.6 per cent of gross domestic product (GDP) in 1984-85 to 16.7 per cent in 1991-92. It will fall to 13.9 per cent, the lowest level in 30 years, by 1996-97.
- The deficit has been cut almost in half as a proportion of GDP since 1984-85. The deficit is projected to decline dramatically to less than one per cent of GDP by 1996-97.
- Financial requirements – the additional funds that must be borrowed on financial markets to help cover the deficit each year – will be eliminated by 1995-96. The government will then begin reducing its publicly held debt.
- The growth of the debt has been slowed significantly. The debt will begin to decline as a share of GDP in 1993-94.

The debt-to-GDP ratio: 1980-81 to 1996-97



Finance Information

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Federal transfers to the provinces

Federal transfers to the provinces – worth some $39 billion in fiscal 1992-93 – help ensure that all the provinces have the means to provide the services Canadians expect. This allows provinces to provide all Canadians with essential public services in areas of provincial responsibility like education, health care, and social services. Transfers also help maintain the Canadian economic union by facilitating the mobility of people across the country since Canadians can be assured of reasonably comparable services wherever they live.

Why transfers are necessary

There are several reasons why intergovernmental transfers are necessary in a federation like Canada. Some of these are:

To reduce interprovincial disparities

Transfers allow provinces to provide roughly comparable services, even if they have different capacities to raise tax revenues. Without such transfers, there would be more or better government services – such as roads, schools and medical facilities – in richer provinces than in poorer ones. This violates the principle of equity that all citizens should be treated in a reasonably comparable way wherever they live.

Through their national taxes, all Canadians assist those living in provinces with less capacity to finance services. Equalization payments are the major means of reducing fiscal disparities among provinces. They reduce the incentive to migrate simply because of more attractive public services or taxation rates. These payments are unconditional, because they are intended to reduce disparities, not influence provincial spending priorities.

In addition to Equalization payments, other transfers also promote equity and fairness by supporting particular pan-Canadian programs and objectives.

To promote national economic management

As part of its overall economic management role, the federal government acts to stabilize the economy. To this end, the government has incorporated "automatic stabilizers" into the tax and personal transfer system. Personal and corporate income taxes are structured so that taxes rise more rapidly than the economy when it is growing, and fall more rapidly than the economy when it is declining.

Transfers to provinces help stabilize the economy. In an economic downturn, provinces can face a cyclical drop in revenues while spending responsibilities increase. Transfers from the federal government help stabilize provincial revenues in these circumstances.

To offset interprovincial "spill-over effects"

Another rationale for intergovernmental transfers is the fact that some actions of provincial governments have effects beyond their boundaries. For example, Alberta benefits from the work of petroleum engineers educated at the University of Saskatchewan. Similarly, doctors and lawyers trained in Nova Scotia universities contribute to every part of Canada.

In the face of such "spill-over" effects, the national interest and the interest of the provincial

governments may not coincide – and provinces may tend to underspend. There is no ill-will involved; it is a natural result of decisions taken from the legitimate perspectives of each jurisdiction.

Intergovernmental transfers address this "spill-over" problem by inducing the jurisdiction providing a particular service to take a broader view and provide a level of service more appropriate to the national interest.

To develop and maintain national standards

The need for transfers also arises when the federal government wishes to develop or maintain programs of national importance in an area that formally lies within provincial constitutional responsibility, or when it feels the national interest is best served by common standards that are higher or different than those individual provinces might be expected to meet on their own. In such cases, the federal government can offer to fund some portion of the program, providing each province respects certain national objectives or standards.

National standards, however, should not be used to undermine a province's ability to meet local needs and preferences in areas of provincial jurisdiction.

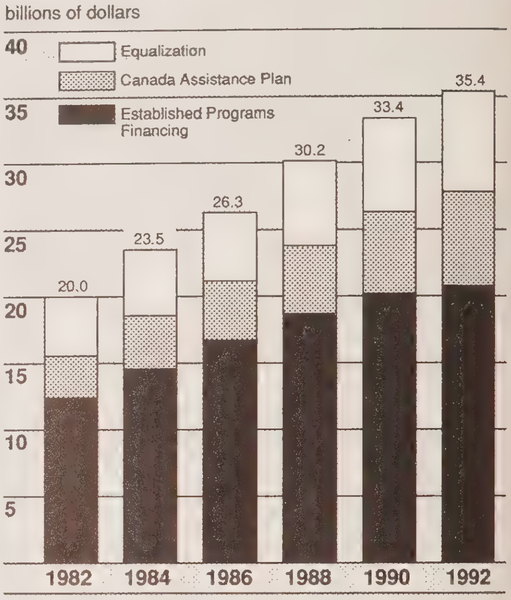
Major federal transfers

For 1992-93, total federal transfers to the provinces and territories will be almost $39 billion. For the most part, provincial governments can use this money to fund programs and services according to their needs and priorities.

The three largest transfers are the Established Programs Financing, Equalization, and the Canada Assistance Plan.

Major federal transfers to the provinces have grown rapidly over the last decade, with an average annual rise of 5.4 per cent since 1984-85. These transfers have grown more rapidly than federal program spending over the same period.

Major federal transfers 1982-83 to 1992-93



As shown in the chart on the next page, major transfers amount to between 20 and 44 per cent of provincial revenues.

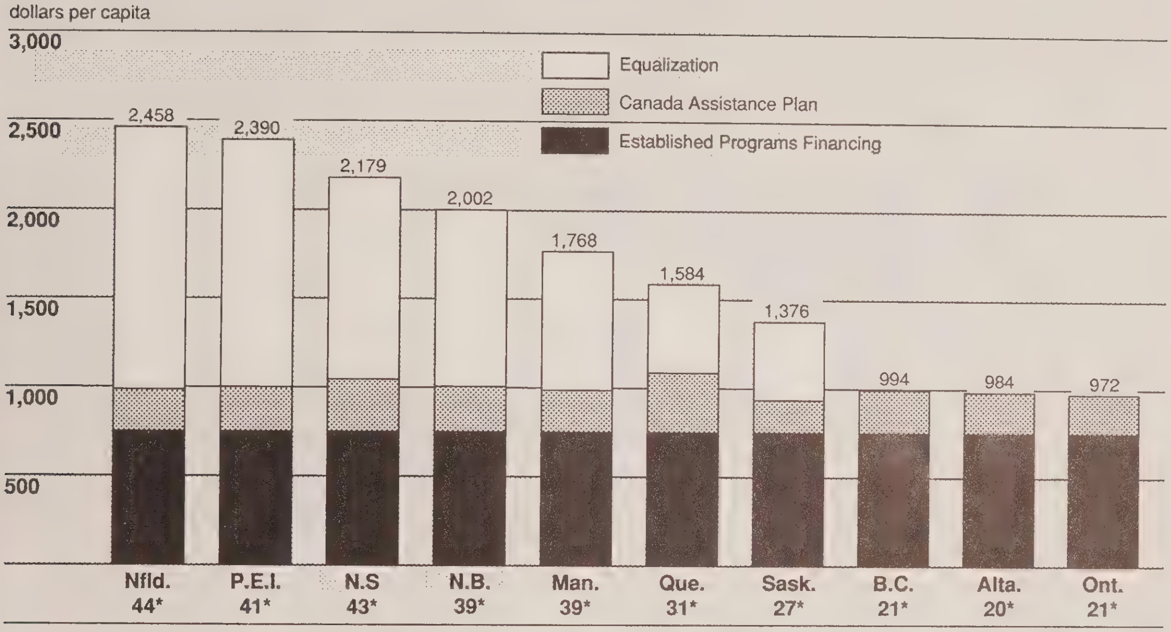
Established Programs Financing

Established Programs Financing (EPF) is the largest single source of federal assistance to provinces. It supports health care and post-secondary education programs provided by the provinces. EPF transfers will exceed $20 billion in 1992-93. As part of a broad package of spending controls, per capita EPF transfers have been frozen through 1994-95. As a result, total EPF will grow only with population, or about 1 per cent annually.

Federal support for health and post-secondary education goes back many years, with the federal government sharing the cost of many programs. However, at no time was there a straight "50/50" sharing of costs, since sharing rules differed from program to program, and not all provincial spending in these areas was eligible in determining federal assistance.

Because of different definitions of costs, sharing formulae, per-capita overrides and growth

Major federal transfers
1992-93



* Per cent of provincial revenues.

ceilings, the federal share of hospital insurance costs varied across the provinces from 47 to 60 per cent, the share of medicare from 41 to 75 per cent, and the share of post-secondary education from 43 to 76 per cent (based on 1976-77 data).

With the advent of block-funded EPF transfers to the provinces in 1977, federal contributions were no longer related to provincial expenditures in program areas. All governments agreed to end cost-sharing in favour of equal per-capita block funded transfers. Today, the federal contributions are unrelated to individual program costs, and therefore "shareable cost" statistics are no longer kept.

Equalization

The second largest transfer, Equalization, provides substantial assistance to the seven lower-income provinces. This year, Equalization transfers will top $8 billion.

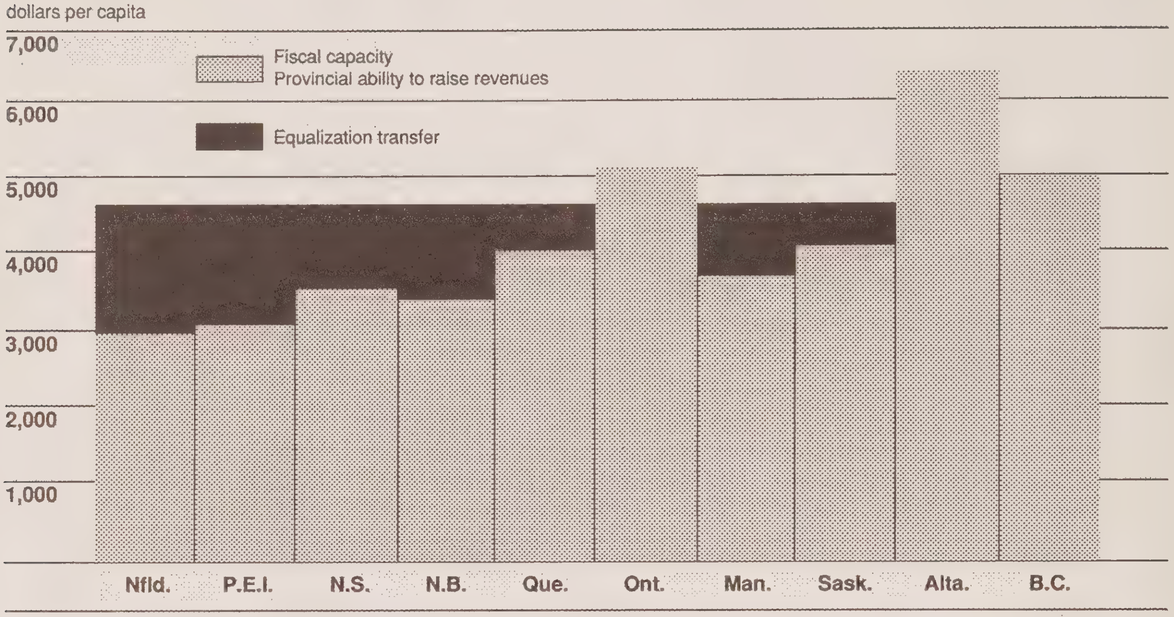
The purpose of Equalization is to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.

Equalization payments are calculated on the basis of a formula set out in federal legislation that compares the overall capacity of provinces to raise revenues (see chart on next page). The revenue-generating capacity of any province that falls below the program standard is raised to the standard through federal Equalization payments.

The Canada Assistance Plan

Under the third largest transfer program – the Canada Assistance Plan (CAP) – the federal government provides just over $7 billion to all provinces and territories to assist them in providing social services and social assistance. As part of the government's Expenditure Control Plan, the growth in CAP contributions to the three

How Equalization works
1991-92



provinces not receiving Equalization (Ontario, Alberta, and British Columbia) will be held to 5 per cent annually through 1994-95.

By helping the provinces support needy Canadians, CAP has become an essential underpinning for this country's social safety net. The primary objectives of CAP are to support the provinces in providing adequate levels of social assistance and institutional care for persons in need, and in providing welfare services that aim to lessen, remove or prevent the causes and effects of poverty, child neglect, or dependence on public assistance.

The future of transfers

Today's major transfer programs are a legacy of the 1960s and 1970s, when Canada's fiscal and economic circumstances were quite different. The systems of major transfers will need to meet the new challenges, needs, and priorities of the 1990s, within necessary fiscal parameters that result from the federal government's commitment to fiscal responsibility.

The federal government will ensure that in the future, the system of transfers maintains the principles and standards that are the basis of Canadian citizenship while respecting provincial flexibility. As well, the transfer system will continue to support a more efficient and competitive Canada while preserving the national commitment to share the opportunities and benefits of Confederation.

More information on federal transfers to the provinces is available in a 28-page booklet that bears the same title as this information sheet (Federal Transfers to the Provinces). It is available on request from the Department of Finance Distribution Centre (613) 995-2855.

Finance Information

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Economic advantages for business in Canada

Canadians enjoy a high standard of living – second among the major industrial nations. This prosperity is underpinned by the creation of meaningful, stable jobs by the private sector, capitalizing on this country's resource strengths – both natural and human. While governments cannot legislate prosperity, their policies can create a positive environment in which business can compete and be successful. This information sheet examines some of the government policies that help provide real economic advantages for business operating here.

Tax competitiveness

The tax system, including the type and level of taxation, plays an important role in determining Canada's competitiveness. Canada's total tax revenues – federal, provincial and local – were equal to roughly one-third of our GDP in 1989. Among the G-7 group of large industrial countries, this is a lower proportion than in France, Germany, Italy and the United Kingdom.

Since 1984, the federal government has made fundamental reforms to the tax system, to lower federal income tax rates, increase fairness, and eliminate major economic distortions that impede productive investment.

A major tax reform was the replacement of the job-killing Manufacturers' Sales Tax (MST) with a Goods and Services Tax (GST). This measure eliminated the federal sales tax on business inputs, thus lowering the cost of investment and strengthening the ability of firms in Canada to compete at home and abroad. This tax reform ensured that Canadian goods are taxed fairly, and not more heavily than imports.

Canadian companies also benefit from one of the most generous systems of tax incentives for research and development in the world. The 1992 budget proposed to further enrich R&D tax credits by $230 million over five years and streamline their administration to make them more efficient.

To encourage long-term economic growth, the 1992 federal budget announced a number of changes to the tax system that strengthen the competitiveness of Canadian business. These included an increase in the capital cost allowance rate for manufacturing and processing equipment from 25 to 30 per cent and a decrease in the tax rate on manufacturing and processing profits from 23 to 21 per cent. For a Canadian company not subject to withholding tax, this rate reduction will

provide a statutory tax rate in Canada that is significantly lower than the rate applied to its competition in the U.S. As well, the government announced that it is prepared to negotiate bilateral tax treaties that would lower the withholding tax on direct dividends to non-residents to 5 per cent over a five-year period.

The federal tax system also provides considerable support for small businesses. Federal taxes payable by these enterprises have been reduced by more than $3 billion through a number of measures, including lower tax rates for small business, special treatment for capital gains, and enhanced incentives for R&D.

While the tax system is a consideration in fostering competitiveness, other factors are equally important, such as the overall economic situation, market conditions, and in particular, the actions by government, business and labour to enhance productivity and contain costs.

Low inflation

A stable, low-inflation environment allows businesses to plan and invest more confidently for the longer term, and reduces distortions in investment decisions.

With a goal of price stability, the government and the Bank of Canada last year announced firm targets for reducing inflation.

To date, inflation has been well under the target level, with the year-over-year inflation rate averaging 1.5 per cent over the first half of 1992 – the lowest sustained level since 1962. Currently, Canada's inflation rate is the lowest among the G-7 countries, the seven largest economies in the world.

Low interest rates

Low interest rates – made possible by the easing of inflation – reduce the cost of borrowing money for new investments that businesses need to stay competitive and seize new market opportunities.

From a peak of 14.05 per cent in May 1990, the Bank of Canada rate had fallen to the 5.5 per cent range by mid-1992.

The prime rate charged by Canadian banks has gone down 8 percentage points over the same period, from a high of 14.75 per cent two years ago to 6.75 per cent. For a business with a $100,000 loan amortized over 10 years, an 8-percentage-point drop means a savings of $450 per month.

As well, the difference between U.S. and Canadian prime rates had shrunk from 4.75 percentage points in May 1990 to 0.75 percentage points, by mid-1992.

Moderating wage settlements

Wage costs are an important factor in determining the ability of businesses to compete. Demands for wage increases have moderated as inflation has eased and Canadians begin to experience a much slower rise in the cost of living.

This easing in the growth of wage settlements and unit labour costs over the last year will strengthen Canada's ability to compete successfully against other industrial nations.

Average wage increases have moderated from a peak of 6.1 per cent in the first quarter of 1991 to 2.9 per cent in the first quarter of 1992. Private sector wage increases have declined

from 6.4 per cent in the third quarter of 1990 to reach a level of 2.7 per cent in the first quarter of this year. Public sector wage increases have declined from a 6.4 per cent rate of growth in the first quarter of 1991 to 3.0 per cent in the first three months of 1992.

Moderating wage costs have played an important role in reducing the growth in unit labour costs – an important measure of international competitiveness. Thanks to increases in productivity by businesses and workers, growth in unit labour costs has declined from 8.6 per cent in the first quarter of 1991 to 0.4 per cent for the first quarter of this year. The lower cost increase in the first quarter reflected a 4.1 per cent surge in labour productivity from the level seen in the fourth quarter of 1991.

Advantageous social programs

Canada's social programs, along with the economic strength that underpins them, are a key reason why this country has been ranked first in the world by the United Nations in terms of human development.

In particular, Canada's commitment to education and health care provide a competitive edge for Canadian businesses and the workers they employ.

Commitment to education and training

Canada spends more than 7 per cent of its gross domestic product (GDP) – about $50 billion – on education and training, more than any other member of the G-7 group of major industrial countries.

One mark of our success in education is Canada's two million university graduates – giving us the highest per capita number of graduates in the world. However, more needs to be done, especially in technology-intensive fields and skilled trades.

In response to this need, the federal government supports programs to help workers adjust to changing requirements of labour markets. For example, the Labour Force Development Strategy has earmarked some $1.8 billion from the unemployment insurance program to provide UI recipients with income support and to cover certain other costs while they train for new employment.

An important objective of the Prosperity Initiative launched by the federal government is to develop a consensus among stakeholders in the economy and the various levels of government on the best way to improve our education and training systems.

Universal health care

Canada's universal health care system also provides important economic benefits. Our system ensures health care for everyone at a cost of just over 9 per cent of GDP, or about $2,300 per person. In comparison, the U.S. – a country that does not have a universal health care system – spends over 12 per cent of GDP on health, or Cdn$3,000 per capita. In spite of the higher cost, some 35 million Americans lack insurance coverage and another 15 million are underinsured. Consequently, our system provides quality health care at a much lower cost – freeing money to invest in the economy.

A more efficient health care system benefits all sectors of the economy. The employees of all companies, both large or small – and the self-employed – are not saddled with the high costs of an inefficient insurance system.

Universal coverage also facilitates labour mobility, as workers can move to better jobs, including jobs in other provinces, without fear of losing health care coverage.

Beneficial structural reforms

Since 1984, a number of regulatory reforms have removed artificial barriers to business operating efficiently in the marketplace. For example, the energy and trucking industries have been deregulated, making them more competitive. As well, the federal government has implemented wide-ranging reform of the regulations governing the financial industry – increasing the competitiveness of an industry that is known worldwide for its stability and efficiency.

Along with these domestic reforms, the government is also working to negotiate reductions in the barriers Canadians face in exporting goods and services. This is important for a country that is one of the world's major exporters, with some 25 per cent of our economic output – and millions of jobs – depending on foreign markets.

The government has also taken steps to remove impediments to foreign investment by replacing the Foreign Investment Review Agency with Investment Canada. As well, foreign investment restrictions in the energy sector have been removed.

Since the implementation of the Free Trade Agreement with the U.S. in 1989, Canadian exports to the U.S. have grown significantly, up almost 11 per cent from the last quarter of 1988 to the first quarter of 1992, when exports were $28.5 billion ($114 billion at an annual rate). As well, investment in this country has increased significantly over this period, moving from a net investment outflow of $2.1 billion in 1988 to a net inflow of $1.5 billion in 1991.

Deficit control

The federal deficit and debt are not just fiscal problems: they force the government to compete with the private sector in financial markets for Canadian savings, thus pushing interest rates up and reducing the availability of investment capital. Reducing the deficit will help interest rates come down further and remain low.

Since 1984, substantially more progress has been made in Canada than in the U.S. in reducing the deficit. In the U.S., the deficit – measured by the unified budget balance – has actually risen from 5.3 per cent to a projected 6.8 per cent of GDP from 1984-85 to 1991-92. Using the comparable Canadian accounting definition – our financial requirements – the federal deficit here fell from 6.7 to 4.7 per cent during the same period. This progress has been made despite the recent economic downturn.

Much of the fiscal improvement in Canada results from the government's spending restraint. In 1984-85, program spending was $1.33 for every dollar of federal tax revenue – resulting in a $16.1 billion operating deficit. This year, with 97 cents of every tax dollar going to programs, a $12.7 billion operating surplus is expected.

More information on the topics covered in this document is available in other information sheets published by the Department of Finance. These include:

- *The 1992 federal budget*
- *Tax support for small business*
- *Tax changes for manufacturing and processing*
- *Canadian tax facts*
- *The benefits of reduced inflation*
- *The Goods and Services Tax (GST)*
- *Federal transfers to the provinces*

Finance Information

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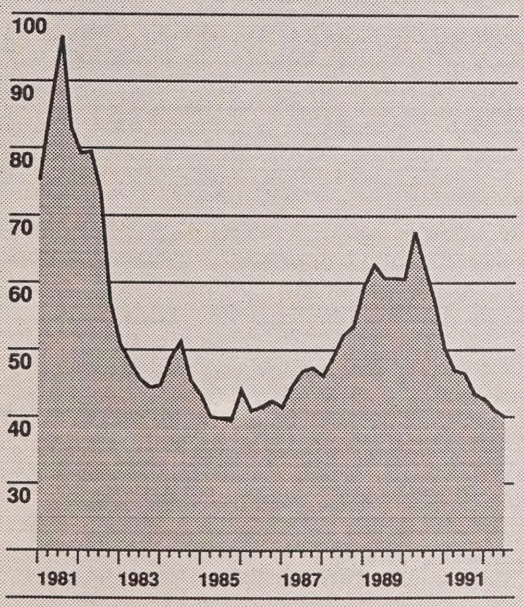
Housing affordability

The affordability of housing in Canada has improved dramatically since the middle of 1990 and is now approaching its best level in the past ten years.

Housing more affordable

Housing affordability – the proportion of disposable income an average household would need in order to meet mortgage payments on a new home (amortized over 25 years with a one-year mortgage rate and a 10 per cent down payment) – has improved sharply in the past two years.

Housing affordability
Percentage of income needed to meet mortgage payments



Note: The index of housing affordability in this Information Sheet is slightly different from the index used in a previous version. The revised index is constructed using the average price of *all* new houses instead of the price of *starter* houses. In practical terms, this change affects the level of the index but not the rate of change.

From the second quarter of 1990 to the second quarter of 1992, housing affordability improved by an estimated 39 per cent.

This means housing is now more affordable than at any time since 1985, the year in which housing was most affordable in the 1980s.

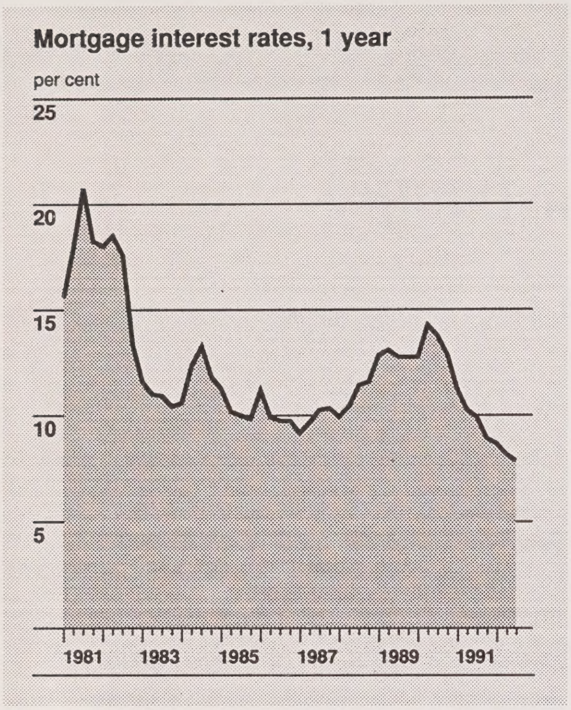
Two factors are responsible for this improvement:

- sharp declines in mortgage rates; and
- a decline in the average price of new housing in Canada.

Mortgage interest rates low

Almost 90 per cent of the improvement in affordability seen in the last two years comes from a sharp decline in mortgage rates. The one-year mortgage rate has fallen 7.75 percentage points since the second quarter of 1990 to 6.5 per cent in August 1992, the lowest level since this term was first introduced.

The five-year rate has also declined 5.5 percentage points since the second quarter of 1990 to 8.75 per cent in July, its lowest level since 1967. These significant



declines in mortgage rates over the last two years were assisted by the government's policy framework of clear inflation targets, fiscal discipline and wage restraint.

Housing prices

Strong demand for housing, combined with speculative pressures fed by rising price expectations, helped inflate new house prices by more than 50 per cent in the second half of the 1980s, especially in the Toronto area. Part of this increase has been reversed since the beginning of 1990, with the average price of new homes in this region falling almost 20 per cent. This correction in housing prices has contributed about 10 per cent of the improvement in the national housing affordability index over this period.

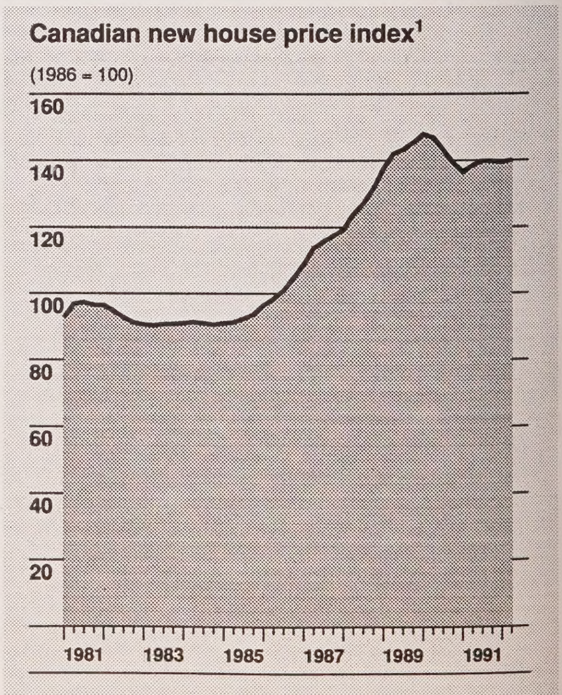
Most other cities, however, have continued to experience price increases. In Halifax, Montreal, Winnipeg, Edmonton, and Vancouver, new house prices rose moderately – 7 per cent or less – in the last two years, while prices rose 12 per cent in St. John's. Even in these centres, the decline in mortgage rates has dramatically improved affordability.

The Home Buyers' Plan

The 1992 federal budget announced the government's new Home Buyers' Plan, which now allows individual Canadians to withdraw up to $20,000 from their registered retirement savings plans (RRSPs) and use the funds to buy or build a home. The home buyers can then repay the amount over 15 years. This measure continues in effect until March 1, 1993.

The Home Buyers' Plan assists Canadians to take advantage of low mortgage rates and moderate house prices. It also helps home buyers to take advantage of the reduction to 5 per cent in the down payment required for CMHC-insured mortgages.

These programs have already helped a large number of Canadians to purchase or build homes. As of the end of July, about 37,000 households have taken advantage of the lower down payment requirement implemented prior to the budget; and about 46,000 applications to withdraw RRSP funds to purchase or build a home were received by Revenue Canada by the end of June.



[1]Statistics Canada Analytical Index.